

Federal CFO Insights

Aligning internal controls and enterprise risk management frameworks

Background

Many Federal government agencies have successfully developed and implemented internal control frameworks that are now required by congressional mandates. However, the ultimate objective of effective internal controls is to help the agency achieve its mission, including desired outcomes at the best value for taxpayers. Chief Financial Officers (CFO) are usually the spearhead for determining how robust and effective internal controls will efficiently harmonize with mission oriented processes, systems, and people. Complicating this goal is the often heard lamentation that cost cutting demands have resulted in CFOs not making the needed investments for improving key components of the internal control framework such as financial systems, internal control redesign, workforce performance, and better governance. Not to be overlooked is the perennial pressures on CFOs to adjust to the ever changing political environment and increasing public scrutiny. Taxpayer focus on government spending versus outcomes is at an all-time high and the CFO is the agency's best line of defense and champion for addressing these challenges.

The CFO should have a well thought out strategy for rationalizing the design of internal controls. Given that consideration of risk is the primary design criteria for internal controls, CFOs should fully leverage the organization's Enterprise Risk Management (ERM) framework and risk assessment results to routinely assess the effectiveness of existing internal controls and provide a basis for moderating their design for optimum cost and efficiency. Another primary consideration is change in the organization's mission and overall risk environment which are often key drivers for identifying and assessing the broad range of risk that the organization must effectively manage.

This article will provide Federal CFOs with a helpful approach to consider for aligning the agency's Internal Control Framework with the results of its ERM program.

Understanding risk and controls

Aligning Internal Controls and ERM will require the CFO and agency senior leadership to better understand the organization's true risk exposure and the current state of risk management effectiveness, especially around emerging risks. This will require the organization to invest the prerequisite time and attention to achieve full-spectrum risk awareness and more effective coordination and communication in its risk management processes. This involves first understanding the full range of risk that fundamentally underlay all operations. Once these risks are known and understood, the CFO can assist management deciding how to best manage these risks within acceptable levels of effectiveness. Ultimately, the question is not how to eliminate risk, but rather how does the agency manage risk?



Major areas of risk facing federal agencies

Many agencies face a common set of risks that could impact mission achievement, including but not limited to the following:

- **Reputation risk:** Maintaining the public trust by consistently meeting expectations in areas of integrity, quality, safety, fairness, and reliability.
- **Political risk:** Preparing for and managing the impact of changing political priorities on operations, funding and resources, as well as planning to minimize the angst associated with election cycles
- **Key infrastructure risks:** Identifying and managing risks to key infrastructure, as well as overseeing and assessing subsequent risk management efforts carried out by facility owners and operators.
- **Human capital risks:** Identifying root causes associated with human capital issues, as well as planning for challenges associated with retirement, decreases in available funding and knowledge retention
- **Compliance and regulatory risks:** Managing the increased rigor of internal controls required by regulations and handling the complexity of the required compliance activities
- **Transparency and accountability risks:** Providing taxpayers with increased visibility into management processes, performance and spending
- **Information technology risk:** Evaluating systems in accordance with current and future business requirements and ensuring that systems and databases are secure and capable of preventing data corruption and misuse

Applicable risk management regulations and standards

To address the above range of risks to mission achievement and to maintain public trust, several laws and regulations have been passed that require Federal agencies to:

- Establish and maintain internal controls necessary to mitigate risks; and
- Support achievement of their objectives

These laws, regulations and guidelines include:

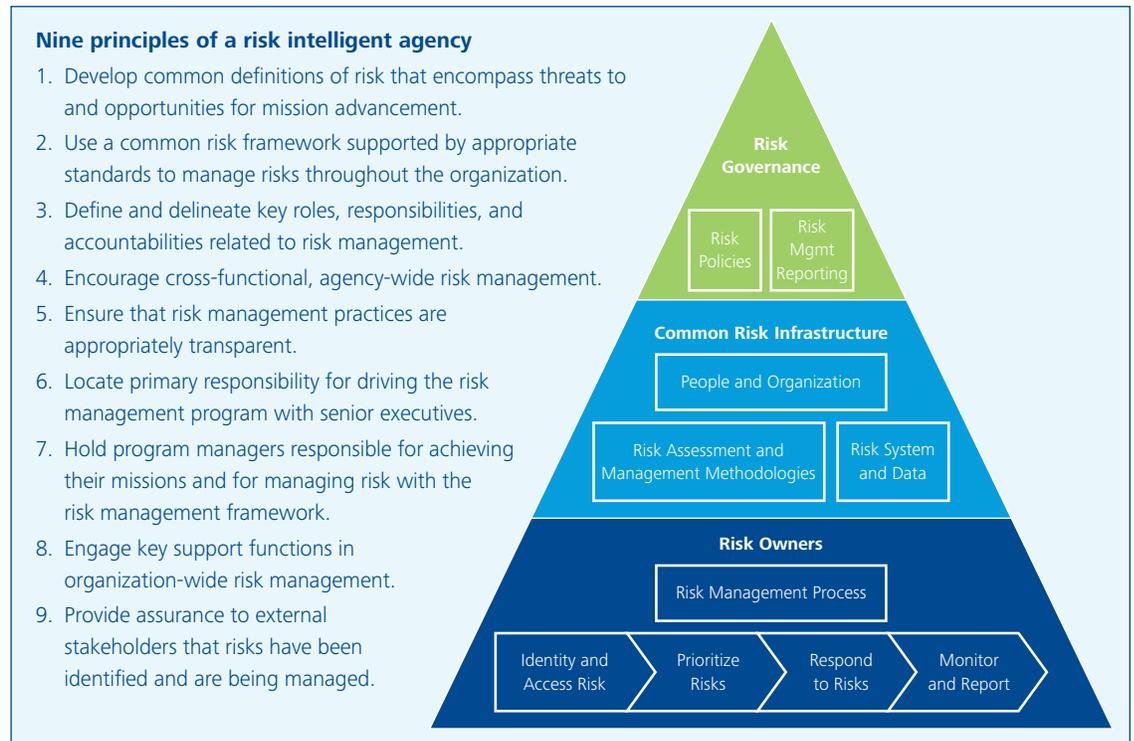
- **Federal Managers Financial Integrity Act of 1982:** Requires ongoing evaluations of and reports on the adequacy of internal accounting systems and administrative controls of each executive agency.
- **Office of Management and Budget Circular A-123 — Management’s Responsibility for Internal Control:** Requires continuous internal control assessment led by agency management at financial reporting levels.
- **The Chief Financial Officers Act of 1990:** Requires CFOs to maintain effective internal controls in processes and systems.
- **U.S. Government Accountability Office (GAO) — Standards for Internal Control in the Federal Government GAO/AIMD-00-21.3.1 (11/99):** Provides general guidance for including risk assessment as an integral component of an agency’s internal control framework.
- **Federal Information Security Management Act of 2002:** Requires each agency to develop, document, and implement an agency wide information security program providing information security protections commensurate with the risk and magnitude of the harm resulting from unauthorized access, use, disclosure, disruption, modification, or destruction of:
 - Information collected or maintained by or on behalf of the agency; and
 - Information systems used or operated by an agency or by a contractor of an agency or other organization on behalf of an agency.
- **Government Performance and Results Modernization Act of 2010:** Provides guidance for identifying and managing risks to the achievement of priority Federal Government goals and planned levels of performance.



Using ERM to address risk management objectives

In response to these requirements, many federal agencies are implementing ERM programs that provide a broad and unifying approach for improving an organizations overall risk management capability. ERM provides the needed risk intelligence to help management stay in front of emerging risk issues and take proactive measures to reduce the likelihood of risk events or minimize their impact.

Developing an ERM framework that comprehensively manages risks and integrates the current internal control functions and programs need not be overwhelming or difficult. Such a framework can help reduce overall risk exposure by leveraging a standardized and consistent risk management framework that emphasizes risk awareness and communication. To assist in developing this framework, Deloitte has developed the Nine Principles of a Risk Intelligent Agency™. These principles can be used to develop a roadmap to assist a Federal agency on its journey to a comprehensive risk management solution.



The value of internal controls in managing risk

A strong internal control framework can also provide reasonable assurance that the agency’s financial reporting and operational objectives are achieved. Once the objectives have been set, the agency needs to identify the risks that impede the efficient and effective achievement of those objectives at the entity level and the process level. The purpose of a risk assessment is to identify, analyze, and manage risks relevant to achieving the objectives of a given process, activity, program, project, function, or system. The risk assessment methodology is basically the same and typically involves the following:

- Identify the nature of the risk(s) and calculate risk ratings at the sub-process, process, and entity levels, where each calculation feeds into the next level



- Provide a basis for prioritizing resources and rationalizing controls based on inherent risk
- Determine the best course of action to strengthen the controls that will most effectively mitigate the subject risk

The analysis performed in the internal control program is performed at a detailed level and can be leveraged and built upon throughout the organization.

Strategy for moving forward

Using the components of the Committee of Sponsoring Organizations of the Treadway Commission’s (COSO) 2013 Internal Control — Integrated Framework as a model, an organization can develop specific strategies for aligning internal control objectives to their ERM program. Outlined below are a few considerations for getting started.

Control Environment	Leverage ERM’s Risk Oversight mechanism to drive focus on effective risk controls
Risk Assessment	Leverage ERM tools, methods, and training to enhance organizational capability to assess and respond to risks across the enterprise
Control Activities	Leverage the integrate control framework as the first line of defense for managing risks to operational and compliance objectives
Information and Communication	Leverage enterprise communications and reporting vehicles to provide a top-to-bottom pathway for identifying and escalating emerging risks
Monitoring Activities	Leverage ERM as a source for monitoring changes in the organization’s risk environment and evaluating overall risk management effectiveness

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