An effective control framework helps management achieve organizational objectives and create value for stakeholders.

DRIVEN BY INCREASINGLY RIGOROUS GOVERNANCE CODES, capital markets are paying closer attention to company risk management than ever before. The underlying belief is that better risk management — enhancing an organization's ability to deal with the uncertain future — heightens the odds of accomplishing business objectives to the satisfaction of stakeholders. Focusing more attention on risk, many believe, supports the best interests of the enterprise and the people it serves.

In reality, however, a risk-centric focus can mask the significance of internal controls. Because the root cause of risk

Delivering on your Promises

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often resides in common control deficiencies, management's primary emphasis should be on ensuring adequate and effective internal control. The main goal of risk assessments should be to analyze the effectiveness of the organization's control framework, not just to identify and prioritize key risks.

The organization's control framework ultimately enables management to deliver on its promises and achieve organizational success. Management should establish controls not only to mitigate risks ("What could go wrong?"), but to ensure objectives are achieved ("What should go right?"). Corporate focus should be aimed at establishing a framework that helps safeguard and optimize the use of assets and creates value for stakeholders.

THE IMPORTANCE OF CONTROLS

A control can be defined as any specific action by management to achieve the organization's objectives. Controls represent the "rules of the house" that govern essential organizational activities, including asset safeguarding, customer service, employee reward and appraisal, information security, transaction authorization, and client safety. They play a key role in the organizational structure, enabling top management to stipulate the types of decisions local management can make, as well as those that should come from the corporate office. Controls also help ensure that subordinates act in the interest of the organization by establishing expectations for each function. The quality of controls directly impacts the quality of business processes by establishing their reliability and level of outcome variability.

An internal control framework represents the structured combination of all controls within the organization, comprising all of the organization's charters, policies, procedures, instructions, and manuals (see "Internal Control Framework" on page 67). The framework is also the standard against which internal auditing should perform audits. In its consulting role, for example, the audit function assists management with recommendations regarding the design of the control framework; in its assurance role, internal auditing independently verifies that the controls operate effectively.

KEY FRAMEWORK CONSIDERATIONS

Effectively managing the control framework is key to providing adequate guidance to all employees and ensuring management can carry out its responsibilities. To establish or optimize the framework, management needs to address four key attributes (see "Four Basic Control Framework Questions" on page 68).

GOVERNANCE Who decides the rules of the house and determines when they will be issued or updated, or whether they are consistent and cost-effective? Essentially, who controls the controls? Governance over controls guides the logistics of issuing and updating the rules of the house to ensure they do not conflict with each other. Top management must decide the individual responsibilities of each function and establish coordination entitywide to avoid the typical gaps and overlaps endemic to a silo-based approach. Communications related to objective setting, risk appetite, and cost-benefit considerations are key to effective governance over controls. Moreover, the governance process should ensure that risk assessments, audits, and control evaluations are conducted in an organized manner.

The main objective of risk analyses should be to assess the design effectiveness of the organization's internal control framework, not just to identify and prioritize key risks.

DESIGN Are the existing rules of the house adequate to achieve the organization's objectives? The answer is determined largely via the outcomes of risk analyses. In the event of changes to external regulations, management needs to ensure controls are adapted where necessary. The main objective of risk analyses should be to assess the design effectiveness of the organization's control framework, not just to identify and prioritize key risks.

EXISTENCE Have the rules been embedded in the organization's daily processes (i.e., have they been implemented, documented, and communicated effectively)? Company rules need to be consistent from top to bottom and prevent conflict among the issuing functions. The rules should also be easily accessible for everyone to whom they apply via, for example, an intranet portal. Of course, the appropriate level of formalization and documentation varies by organization, based on factors such as culture, size, and history.

OPERATION This attribute pertains to ensuring that controls operate as designed. Do management and employees follow the rules of the house? Does management have assurance that the controls are effective? These questions are answered through monitoring activities such as direct management supervision, self-assessments, surveys, internal and external audits, and letters of representation.

Internal auditors should keep in mind that the rules for addressing these four attributes — the so-called "meta-controls" or "second loop controls" — are part of the framework itself. For example, the audit charter and work programs, which help auditors assess the control framework, are also essential framework components.

OPTIMIZING THE FRAMEWORK

Organizations need to establish a pragmatic yet systematic approach to managing their internal control framework. An effective process is essential to the job of management as it sets business objectives, just as it is vital to employees in supporting the achievement of those objectives.

In practice, organizations often modify their control framework in a reactive, project-oriented manner instead of using a more proactive, process-based approach. In response to new regulations, for example, the organization's various functions tend to build multiple subframeworks, or "compliance silos," composed of communications, tools, manuals, templates, surveys and assessments, reporting protocols, dashboards, audits, etc. These subframeworks can easily lead to both overlapping and conflicting rules, as well as risk areas that lack appropriate coverage. Moreover, they can result in confusion, frustration, and inefficiency throughout the organization.

To keep necessary rules to a minimum and ensure consistency enterprisewide, organizations must structure their control framework effectively. Several specific actions can help management establish a comprehensive and consistent framework:

- Identify the individuals responsible for determining current and future rules of the house. (Governance)
- Clarify the organization's objectives, including those pertaining to risk management, risk appetite, and other

Internal Control Framework

An organization's internal control framework comprises all of the charters, policies, procedures, instructions, and manuals aimed at realizing strategic, operational, reporting, and compliance objectives.

Charter — outlines the principles, functions, and structure of a corporate body, such as the charter of the executive board, the audit committee charter, or the internal audit charter.

Policy — describes management's entity-level control objectives and directives for a certain aspect of the organization's operations, such as purchasing, accounting and reporting, or safety.

Procedure — describes how a policy should be implemented at the process level to accomplish the goals and directives of a particular policy, such as a procedure for the approval of expense claims.

Instruction — describes how process-level activities should be executed in day-to-day practice to comply with related procedures. An instruction comprises any document that provides training, edification, or guidance on completing a task or assignment.

Manual — provides a set of related policies, procedures, or instructions, such as a quality manual, an accounting and reporting manual, or an external communications manual.

risk-related decisions throughout the enterprise. (Governance)

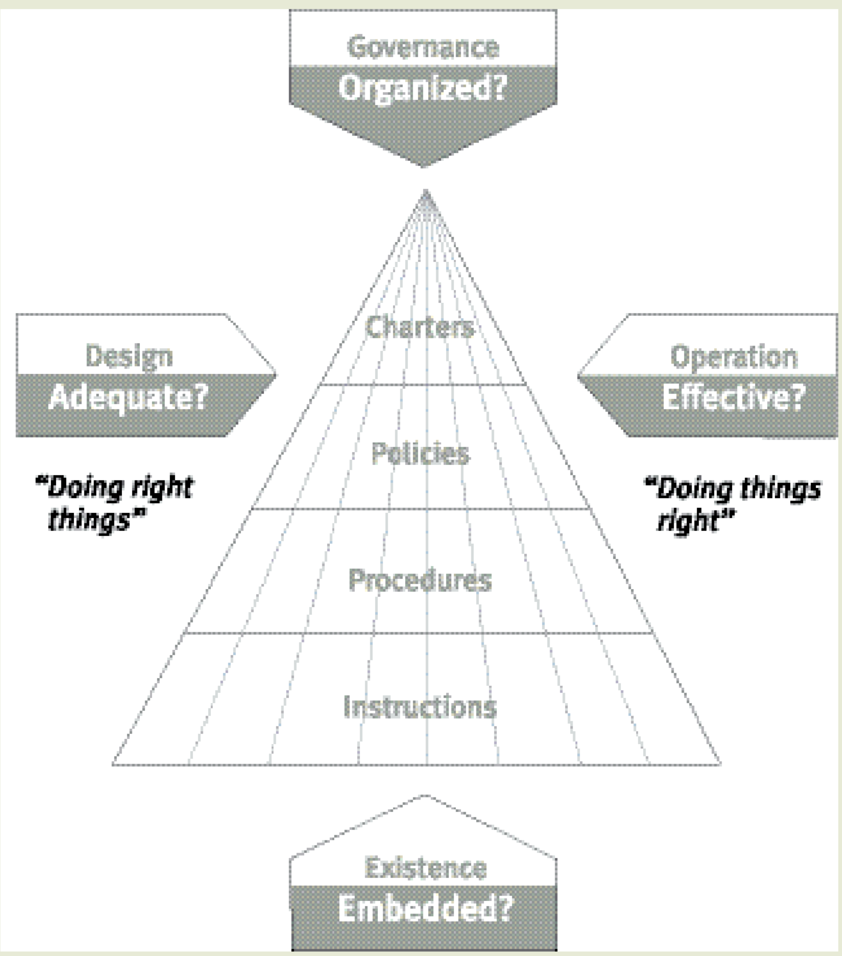
- Perform risk assessments to determine the organization's most significant threats and exposures. (Design)
- Align all reporting along objectives, risks and opportunities, controls, and control operations assurance. Include this information as a key indicator in existing management reporting mechanisms, such as balanced scorecards. (Design)
- Take an inventory of the rules of the house already in place. This process may be time-consuming, as the listing will likely include many outdated rules. (Existence)
- Consolidate all rules in one place and make them accessible to everyone affected, preferably using the organization's intranet. (Existence)
- Apply an expiration date to each rule to indicate when it should be updated or discarded. (Existence)
- For every control, ensure the design process addresses how to determine whether the control actually functions correctly. (Operation)

Once the design of the control framework has been analyzed and adjusted, an appropriate basis exists for establishing the operational effectiveness.

Four Basic Control Framework Questions

The internal control framework's four specific attributes — governance, design, existence, and operation — are illustrated in the pyramid below. The vertical lines within the pyramid represent the organization's multiple functions.

Essentially, management needs to answer four questions to establish or optimize an internal control framework. The answers provide a starting point for helping the organization deliver on its promises.



PRACTICAL BARRIERS

Although the comprehensive, four-attribute control model may appear straightforward in theory, implementation can be complicated. The main challenges stem primarily from human factors, such as corporate politics, diverging views, unwillingness to cooperate, lack of interest, and inflexibility. Moreover, tasks such as assigning responsibility for rule setting and monitoring involve allocation of power, and those who stand to lose power may object to proposed changes. For example, management may need to decide whether the compliance function should perform health and safety audits, or if that area should be the exclusive domain of internal auditing.

The changes necessary to establish a unified framework are difficult to achieve without leadership, support, and clear communication from top management. Indecisiveness at the top can easily lead to unproductive quarrels over corporate territory. Everyone involved in the framework optimization process should keep in mind the perspective of the recipients of the rules of the house and endeavor to facilitate their work efforts, rather than make their lives more difficult. After all, many of these individuals — line management and their employees — typically are the ones who create value for the organization.

MAXIMIZING OPPORTUNITY

An effective control framework enables management to adopt a positive, proactive approach to addressing uncertainty. Companies that merely adopt a positive view of risk, such as focusing solely on achieving returns on the risks they take, fail to leverage the full potential of risk management. Simply taking inventory of what can go wrong does not do justice to important opportunities.

Managing the organization's control framework is part and parcel of effective corporate housekeeping. It is the only way to achieve organizational objectives while keeping the necessary rules of the house to a minimum.

To comment on this article, e-mail the author at marinus.depooter@theiia.org.