Federal Accounting Standards Advisory Board

February 2, 2018

Memorandum

MEMBER ACTION REQUESTED
Provide staff with your thoughts on leveraging ERM Risk Profiling by **February 14, 2018**

To: Members of the Board

Robin M. Gilliam

From: Robin M. Gilliam, Assistant Director

Wendy M. Payne

Through: Wendy M. Payne, Executive Director

Subject: **Risk Assumed[1] – Tab B**

MEETING OBJECTIVE

The objective of this meeting is to determine whether and, if so, how FASAB can leverage enterprise risk management (ERM) risk profiling as identified in OMB Circular A-123.[2]

BRIEFING MATERIAL

The briefing material includes this memorandum and the following attachment and appendices:

Attachment 1: History of Draft Risk Categories Presented

Appendix A: Risk Assumed – Phase II: Project History and Milestones

Appendix B: OMB Circular No. A-123, *Management's Responsibility for Enterprise Risk Management and Internal Control* (A-123)

[1] The staff prepares Board meeting materials to facilitate discussion of issues at the Board meeting. This material is presented for discussion purposes only; it is not intended to reflect authoritative views of FASAB or its staff. Official positions of FASAB are determined only after extensive due process and deliberations.

[2] OMB Circular No. A-123, Management's Responsibility for Enterprise Management and Internal Control, July 15, 2016. See Appendix B for full document

Appendix C: OMB Circular No. A-11, Section 230, *Agency Strategic Planning* (A-11)

Appendix D: Federal Highway Administration *Risk Management Process User Manual,* 2013

BACKGROUND

Phase II of the risk assumed project began in 2016 when FASAB released the *Insurance Programs* exposure draft for comment.[3] The Board approved the following project objective:

> *In phase II, the Board will **holistically review significant risk events** other than adverse events covered by SFFAS 51, Insurance Programs, to determine accounting standards that provide concise, meaningful, and transparent information regarding the potential impact to the fiscal health of the federal government.*[4]

The Board decided to look at all risks assumed holistically instead of creating standards for individual risk event types. However, the Board still wanted to define categories to account for and report risks. Therefore staff presented the following risk category frameworks:[5]

1. At the **October 2016** Board meeting, staff presented a high level analysis **comparing** the International Monetary Fund (IMF) fiscal risks "shocks" **to current FASAB standards.** (See Attachment I, Section I.)

   Board Conclusion: Upon review, the Board agreed that a gap analysis was necessary to determine what risk information is currently presented in financial reports. Once the gap analysis is complete, the Board will discuss how it wants agencies to present risk assumed information going forward, and the extent to which FASAB can align risk assumed standards with the enterprise risk management (ERM) effort.

2. At the **December 2016** Board meeting, staff continued to work with the IMF risk shock categories, added two additional categories, and identified each risk category as related to general or specific events (See Attachment I, Section II)

   Board Conclusion: Upon review, the Board did not want a "laundry-list" of significant events but instead requested that staff develop principles-based broad risk categories.

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[3] The issuance of Statement of Federal Financial Accounting Standards (SFFAS) 51, *Insurance Programs*, on January 18, 2017, effectively concluded the first phase of risk assumed. For the history of the risk assumed project and milestones for phase I, please see http://www.fasab.gov/ra-insurance-programs/

[4] http://www.fasab.gov/risk-assumed-phase-ii/

[5] See Attachment 1 – *History of Draft Risk Categories Presented*

Staff continued working on the gap analysis, using the credit reporting established in SFFAS 2, *Accounting for Direct Loans and Loan Guarantees,* to learn if current risk reporting is efficient and effective.

3. At the **October 2017** Board meeting, staff presented draft principles-based broad risk categories as part of a discussion about credit reform reporting. (See Attachment I, Section III)

According to the preparers that staff interviewed from the Departments of Education and Housing and Urban Development, and the Small Business Administration current credit risk reporting is not an efficient use of resources.[6] As part of the preparer analysis and Board recommendation, staff updated the December 2016 draft risk categories to be more principles-based.

> Board Conclusion: While staff did not request a vote on the updated principles-based broad risk categories presented at the October 2017 meeting, the Board did request that staff continue to develop a risk profile approach.

Staff Analysis and Recommendations

As illustrated in the above section, trying to understand and lock-down **what significant risks are assumed** by the federal government is challenging. To help manage this challenge staff recommends FASAB leverage the ERM terminology and structure of risk profiling as outlined in A-123.

I. A-123 Requires a Risk Profile

A-123, page 13 explains why agencies must maintain a risk profile:

> **B. Risk Profiles[4]**
>
> Agencies must maintain a risk profile. The primary purpose of a risk profile is to provide a thoughtful analysis of the risks an Agency faces toward achieving its strategic objectives arising from its activities and operations, and to identify appropriate options for addressing significant risks. The risk profile assists in facilitating a determination around the aggregate level and types of risk that the agency and its management are willing to assume to achieve its strategic objectives. The risk profile differs from a risk register in that it is a prioritized inventory of the most significant risks identified and assessed through the risk assessment process versus a complete inventory of risks. The risk profile must consider risks from a portfolio perspective and be approved by an Agency's RMC or equivalent. Additionally, the profile must identify sources of uncertainty, both positive (opportunities) and negative (threats).

[6] Staff will discuss findings from round tables of user groups at a future Board meeting.

At the December 2016 meeting, the Board agreed to consider the *extent to which FASAB can align with the ERM effort*. FASAB can align with ERM by leveraging the A-123 blueprint that requires agencies to develop a risk profile.

II. A-123 Blueprint for Developing an Agency Risk Profile

A-123, page 14 identifies seven components of ERM risk profiling

Agencies have discretion in terms of the appropriate content and format for their risk profiles; however, in general risk profiles should include the following seven components:

1. Identification of Objectives
2. Identification of Risk
3. Inherent Risk Assessment
4. Current Risk Response
5. Residual Risk Assessment
6. Proposed Risk Response
7. Proposed Action Category

A-123 incorporates seven already identified steps for developing an agency risk profile. Therefore, leveraging the A-123 blueprint could be efficient for both FASAB and preparers.

III. A-123 Principles-Based Broad Risk Categories

A-123, page 16 identifies objectives for risk identification & analysis

B1. Identification of Objectives

Risk must be analyzed in relation to achievement of the strategic objectives established in the Agency strategic plan (See OMB Circular No. A-11, Section 230), as well as risk in relation to appropriate operational objectives. Specific objectives must be identified and documented to facilitate identification of risks to strategic, operations, reporting, and compliance. This process assists in the identification of formal internal controls and compliance with the FMFIA, as discussed in Section III. In summary, the risk profile must include the following objectives:

- **Strategic Objectives:** relating to the strategic goals and objectives aligned with and supporting the Agency's Mission (See OMB Circular No. A-11, Section 230).
- **Operations Objectives:** relating to the effective and efficient use of the Agency's resources related to administrative and major program operations, including financial and fraud objectives (Refer to Section III, Establishing And Operating An Effective System Of Internal Control).
- **Reporting Objectives:** relating to the reliability of the Agency's reporting.
- **Compliance Objectives:** relating to the Agency's compliance with applicable laws and regulations.

A-123 identifies four objectives that an agency must use in developing a risk profile: strategic, operations, reporting, and compliance. However, A-123 page 16 also suggests that …*Agencies may find it useful to include **additional subcategories** of one or more objectives categories to facilitate communication on a narrower topic…*

By encouraging agency management to drill down to subcategories, A-123 guidance allows agencies to determine how to further categorize risk; therefore addressing and eliminating the need for a "laundry-list." This is principles-based because it is a simple set of key objectives designed to ensure good risk identification and assessment based on each agency's unique and automonimous mission. These flexible guidelines can be applied to a range of situations including a change in strategies that happens at the beginning of each change in administration.

This approach also supports the recommendation and request from preparers—presented at the October 2017 Board meeting—to avoid "prescriptive" reporting. Therefore reducing preparer burden by supporting consistent use of risk terminology.

IV. A-123 AGENCY RISK IDENTIFICATION

A-123, page 16, provides guidance on how to identify risks

B2. Identification of Risk

Identifying risks is a critical step in building the Agency's risk profile. The identification of risk can be separated into two distinct phases:

1. Initial risk identification (for an Agency which has not previously identified its risks in a structured way, or for a new component of an Agency, or perhaps for a new project or activity within an Agency); and

2. Continuous risk identification (which is necessary to identify new or emerging risks, and/or changes in existing risks).

The identification of risk is a continuous and ongoing process. Once initial risks are identified, it is important to re-examine risks on a regular basis to identify new risks or changes to existing risks.

Assessing risk is the next critical step in building the Agency's risk profile, which includes three important principles:

1. Ensure that there is a clearly structured process in which both likelihood and impact are considered for each risk;

2. record the assessment of risk in a way which facilitates monitoring and the identification of risk priorities; and

3. be clear about the difference between inherent and residual risk.

Some risk is unavoidable and beyond an organization's ability to reduce to a tolerable level. Nevertheless, the organization should make contingency plans and manage risks against those plans. For example, many organizations have to accept that risk arises due to natural disaster situations that they cannot control.

Each agency must **intially identify and assess risk** and then provide a **continuous annual risk assessment** according to their unique strategic categories. In addition, as part of risk identity, A-123 recognizes that agency's cannot avoid or manage certain risks such as natural disasters. However, agencies should document *contingency plans and manage risks against those plans*.

A-123's risk profile blueprint could benefit FASAB because it is not a stagnant process. As a result, this dynamic model affords agencies a clear understanding of current risk events that may cause agency objectives NOT to be met and thererfore cause a potential financial impact.

V. A-123 Defines Two Types of Risks: Inherent & Residual

A-123, pages 16-17 defines inherent risk & guidance on how to assess

B3. Inherent Risk Assessment

Inherent risk is the exposure arising from a specific risk before any action has been taken to manage it beyond normal operations. The impact on the Agency's ability to achieve its objectives if the risk occurred can be ranked by appropriate categories, as can the likelihood that each significant risk might occur. While agencies can design their own appropriate categories, for the purposes of this guidance the following illustrative definitions can be used:

Impact

- High: the impact could preclude or highly impair the entity's ability to achieve one or more of its objectives or performance goals;
- Medium: the impact could significantly affect the entity's ability to achieve one or more of its objectives or performance goals; and
- Low: the impact will not significantly affect the entity's ability to achieve one or more of its objectives or performance goals.

Likelihood

- High: the risk is very likely or reasonably expected to occur;
- Medium: the risk is more likely to occur than unlikely; and
- Low: the risk is unlikely to occur.

A-123, pages 19 defines residual risk & how to assess

B5. Residual Risk Assessment

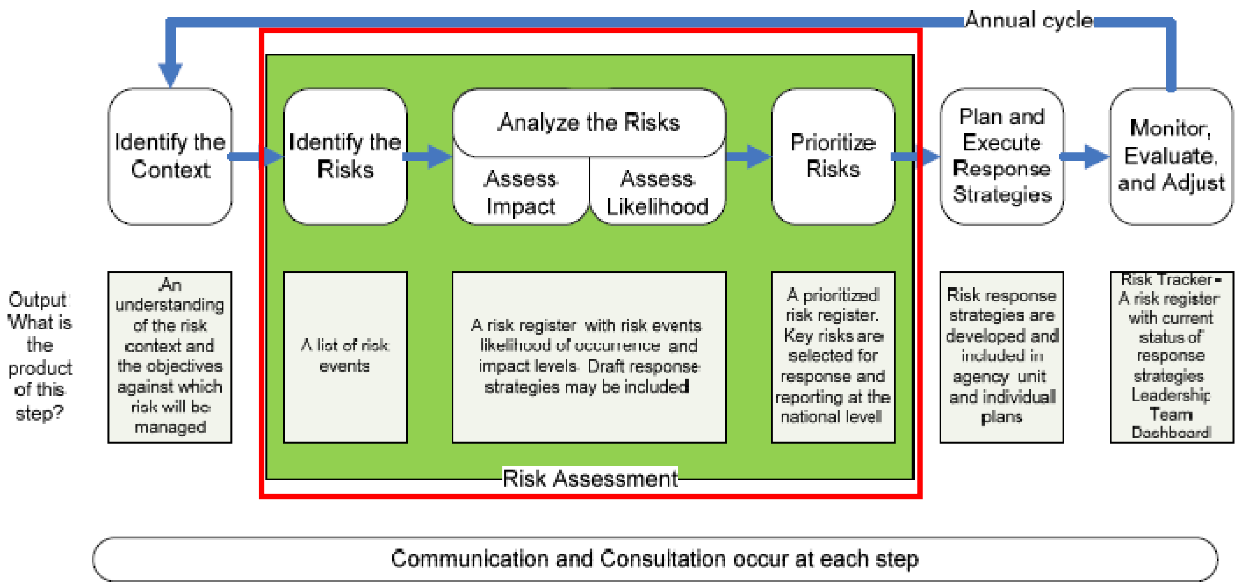
Residual risk is the exposure remaining from an inherent risk after action has been taken to manage it, using the same assessment standards as the inherent assessment.

Once identified, A-123 provides a methodology for assessing the **impact** and **likelihood** of each risk event. This allows management to determine "risk appetite" for when and how to manage each risk. The required annual risk assessment provides agencies with up to date information about risks that are actively being monitored and may have a signficant impact on cash flows.

Leveraging this methodology could provide FASAB with a framework for what significant risks may impact cash flows and financial reporting.

VI. An Agency Example of Risk Profiing as part of Risk Management Process:[7]

FHWA Risk Management Process - Overview and Outputs



[7] Federal Highway Administration *Risk Management Process User Manual*, January 2013, page 1. See Appendix D for entire document.

SUMMARY

OMB circular A-123 has already developed a blueprint for requiring a risk profile as part of an agency's efforts to manage enterprise risk. The identification, assessment, and annual reassessment are a simple set of key objectives designed to ensure good risk identification and assessment based on each agency's unique and automonimous mission. Therefore, these flexible guidelines support FASAB's requirement for principles-based broad risk categories.

Leveraging A-123 ERM risk profiling may also benefit FASAB because 1) agencies are currently implementing it; 2) it supports the risk assumed project's objective to holisticaly review significant risk events for financial reporting; 3) it reduces FASAB staff time and resources for trying to develop separate terminology; and, 4) it may reduce duplication and burden for agency preparers. .

Question 1: What aspects of A-123 risk profiling could the Board potentially leverage for financial reporting?

QUESTION FOR THE BOARD

What aspects of A-123 risk profiling could the Board potentially leverage for financial reporting?

NEXT STEP

Draft risk event definitions and risk profiling standards.

MEMBER FEEDBACK

Please provide editorial input and responses to the above questions to Ms. Gilliam by **Wednesday, February 14, 2018**, at gilliamr@fasab.gov with a cc to Ms. Payne at paynew@fasab.gov

If you have any questions, please contact Ms. Gilliam at 202-512-7356 or gilliamr@fasab.gov

TAB B

RISK ASSUMED II

ATTACHMENT 1

History of Draft Risk Categories Presented

FEBRUARY 2018

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I. Draft Risk Categories Presented at October 2016 Board Meeting

TABLE 1: Analysis of Federal Accounting Standards in Relation to the IMF Recommendations for Disclosing Fiscal Risks

IMF		FASAB	
#	**Fiscal Risks (Sources of risk "shocks")**	**Standards or Active Projects**	**Discussion**
Fiscal Disclosure and Analysis:			
3.1.1	Macroeconomic Risks	SFFAS 36 - *Comprehensive Long-Term Projections for the U.S. Government*	RSI identifies the major factors expected to have a significant impact and how the factors are expected to change over time. RSI provides the results of alternative scenarios based on variations in one or more significant assumptions.
3.1.2	Specific Fiscal Risks	No current requirements	Elements related to risk are reported but not summarized.
3.1.3	Long-Term Fiscal Sustainability Analysis	SFFAS 36 - *Comprehensive Long-Term Projections for the U.S. Government* SFFAS 17-*Accounting for Social Insurance*	Requires projections in basic information along with extensive disclosures and RSI.
Risk Management:			
3.2.1	Budgetary Contingencies	NA	
3.2.2	Asset & Liability Management	Various standards including SFFAS 1, 2, 3, 5, 6, 7, 10, 38, 44 (all as amended)	Assets and liabilities are presented on an accrual basis (with some exceptions such as stewardship land and natural resources) with

IMF		**FASAB**	
#	**Fiscal Risks (Sources of risk "shocks")**	**Standards or Active Projects**	**Discussion**
			disclosures that may address: • sensitivity analysis • range of reasonably possible losses for contingent liabilities A review for consistency regarding such disclosures may be warranted.
3.2.3	Guarantees	SFFAS 2, *Accounting for Direct Loans and Loan Guarantees* SFFAS 51, *Insurance Programs*	SFFAS 2 as amended provides for disclosures but does not require discussion of risks. SFFAS 51 in final stages of ballot, sponsorship review and publication around mid-January 2017. SFFAS 51 will require discussion of risk exposure.
3.2.4	Public Private Partnerships	SFFAS 49, *Public-Private Partnerships: Disclosure Requirements*	Disclosure requirements completed with a focus on risk – recognition/measurement possible future project
3.2.5	Financial Sector Exposure		**Financial Regulations (Banking Sector Risk)** – see discussion below

IMF		FASAB	
#	**Fiscal Risks (Sources of risk "shocks")**	**Standards or Active Projects**	**Discussion**
3.2.6	Natural Resources	SFFAS 38 (Oil and Gas) and Technical Bulletin 20011-1 (Other than Oil and Gas)	RSI provides the value and changes in value of such assets. No senstivity analysis or other risk discussion required.
3.2.7	Environmental Risks		**Disaster Relief** – see discussion below
Fiscal Coordiantion:			
3.3.1	Sub-National Governments		**Inter-governmental & Programmatic Dependency** – see discussion below
3.3.2	Public Corporations (for example, state owned enterprises)	SFFAS 47, *Reporting Entity*	Addressed reporting on risk associated with disclosure entities.
		SFFAS 47, *Reporting Entity*	Defined related parties and noted that **Government Sponsored Enterprises (GSE)** would generally be related parties. Requires disclosures of the nature of the relationship and an understanding of financial risk exposure. – see discussion below.
			Commitments, including contractual, treaties, other international agreements – see discussion below

II. Draft Risk Categories Presented at December 2016 Meeting:

Table I – Recommended Risk Exposure Categories

	Risk Exposure Category	Description	Type
1	Macroeconomic Shocks	The risk that a sharp decline in gross domestic product (GDP) will lead to a large increase in borrowing.	General
2	Financial Sector Exposure – Regulations	The risk of a crisis that calls forth many interrelated government guarantees to stabilize society and the economy.	General
3	Loan Guarantees and Direct Loans	The risk of a large number of loans not able to be collected totaling a significant amount of default that the government must pay to fulfil its legal guarantee.	Specific
4	Public-Private Partnerships (P3)	The risk of failure by the private side of a significant P3 that shifts full financial risk to the government.	Specific
5	Environmental Risks	The risk of a major environmental disaster from the harvesting or transport of natural resources, such as a major oil spill, those demand governmental resources for clean-up.	Specific
6	Natural Disasters	The risk of a natural disaster that causes severe damage, where loans, grants, and other sources of goods and services are required to be provided by the government to a declared disaster location.	Specific
7	Intergovernmental & Programmatic Dependencies	Two types of risks exist here. 1) The risk of intergovernmental partners to efficiently and effectively provide benefits through federal government funding. [Programs administered by states and local jurisdictions to include means-tested entitlement programs and grants for programs such as education, highway, or housing.]	Specific

	Risk Exposure Category	Description	Type
		2) The risk that federal activities operating in state and local jurisdictions will be removed or relocated causing a significant impact on economic health.	
8	Government Sponsored Enterprises (GSE)	The risk that a GSE will suffer significant lack of funding to continue its mission and federal funds will be needed to maintain active status.	Specific
9	Commitments, including contractual, treaties, other international agreements	The risk that a significant commitment will be activated and federal funding beyond budgeted considerations are needed for implementation	Specific
10	Litigation	The risk that a significant law suit is settled for a material amount required to be paid by federal funds	Specific
11	Cybersecurity	The risk that a significant data breach will endanger government operations and/or citizen safety and the current and future cost of correcting that breach to protect citizen's safety is material.	Specific
12	Failed Projects	The risk that a significant project, such as development of internal software, fails by not delivering promised results, wasting a material amount of federal funds.	Specific

III. Draft Risk Categories Presented at October 2017 Board Meeting:

Attachment 1: Draft Principles-Based Broad Risk Categories, Financial Guarantees Category

Principles-Based Broad Risk Categories	**Risk Exposure Types Such as, but not limited to:**	**Draft Definition - Description**
Financial Guarantees	Financial Sector Exposure – Regulations	The risk that a significant event will cause the federal government to pay required or non-required financial guarantees to stabilize the economy [*state in a way that includes bailouts including guarantees not required by the full backing of the us government]*
	Default on Loan Guarantees and Direct Loans	
	Change in interest rate	
	Pay out of Unfunded civilian and military pensions	
	Significant defaults on obligations to the U.S. government	
	Financial condition of state and local governments	
	Environmental Risks – (Water quality - Flint, Michigan,	The risk that an event—man-made or natural—will significantly

Principles-Based Broad Risk Categories	Risk Exposure Types Such as, but not limited to:	Draft Definition - Description
Environmental and/or Citizen socio-economic wellbeing	oil spills, etc.)	affect the environment and/or socioeconomic well-being of persons in the effected geographical areas and requires federal benefits and resources. • Federal help triggered by declaration of state of emergency – activation of Stafford Act. • Multi-agency response (material at GW level, may not be at agency level)
	Natural Disasters	
	Terrorist attacks	
	Sickness or epidemic	
	Social Unrest	
	Intergovernmental & Programmatic Dependencies	The risk that an event involving a party in an interdependant relationship with the federal government causes the government to fulfill its contractual/non-contractual "obligations."
	Government Sponsored Enterprises (GSE)	
	Public-Private Partnerships (P3)	

Principles-Based **Broad Risk Categories**	**Risk Exposure Types** **Such as, but not limited to:**	**Draft Definition - Description**
Interdependencies or **Interdependent Relationships**	Commitments, including: • contractual (i.e. failed projects) • treaties, • other international agreements	(For example: *treaty becomes active, P3 partner goes into bankruptcy; contractor does not meet or fulfill requirements wasting millions/billions amount of funds-government still needs to meet policies*)
Agency Mission - Operation - Strategy	Material litigation settlement	The risk that an event or activity significantly disrupts or distracts operations causing the federal government to provide unfunded (over-budget) resources to return the agency to a functioning state.
	Cybersecurity breach (i.e. disrupts operations, personal/personnel data breach, etc.)	
	National Security (i.e. terrorist or other aggressive acts that ramp up war activities)	
	Cost overruns	
	Social unrest	