

## Risk appetite and criteria compared, considered and developed

### What is risk appetite?

Risk appetite is defined in ISO Guide 73 *Risk management – Vocabulary* as “the amount and type of risk an organisation is prepared to pursue, retain or take”. Other definitions exist including the COSO<sup>1</sup> 2004 definition “risk appetite is the amount of risk, on a broad level, an entity is willing to accept in pursuit of value”.

### Risk defined

Risk is defined in AS/NZS ISO 31000 (paragraph 2.1) as:

Risk is the effect of uncertainty on objectives.

Note 1 An effect is a deviation from the expected – positive or negative.

Note 2 Objectives can have different aspects such as financial, health and safety, and environmental goals and can apply at different levels such as strategic, organisation-wide, project, product, and process.

Note 3 Risk is often characterised by reference to potential events, consequences, or a combination of these and how they can affect the achievement of objectives.

Note 4 Risk is often expressed in terms of a combination of the consequences of an event or a change in circumstances, and the associated likelihood of occurrence.

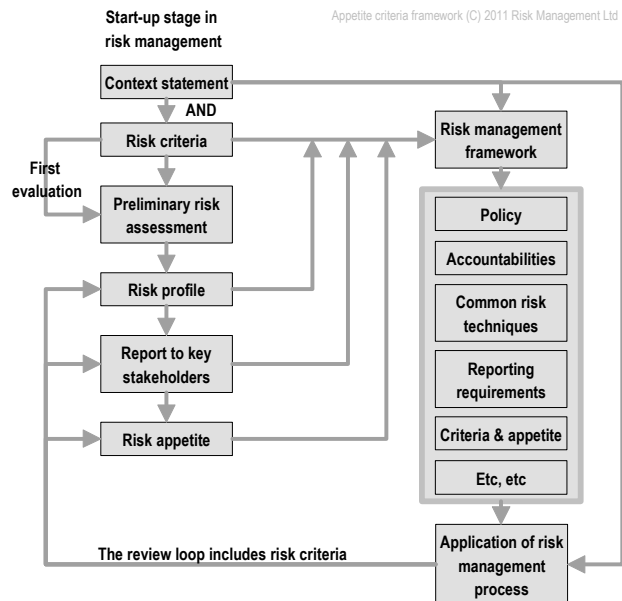
Note 5 Uncertainty is the state, even partial, of deficiency of information related to, understanding or knowledge of, an event, its consequence, or likelihood.

### Understanding the risk appetite

To understand the “amount and type of risk an organisation is prepared to pursue, retain or take” the process set out in the diagram is suggested.

The process starts with the development of a context statement and risk criteria, followed by a preliminary risk assessment that enables reporting of a risk profile to stakeholders and decision-makers who can then state their risk appetite.

Some of the outputs will aid the development of the risk management framework and application of the risk management process. Later, this start-up stage will become a review stage.



### Establishing the context and criteria

A thorough context description is critical to understanding the organisation, developing the risk management framework and applying the risk management process. It also enables the development of risk criteria.

Establishing the context means “defining the external and internal parameters to be taken into account when managing risk, and setting the scope and risk criteria for the risk management policy”. AS/NZS ISO 31000 provides guidance on establishing the context. The standard states:

*By establishing the context, the organisation articulates its objectives, defines the external and internal parameters to be taken into account when managing risk, and sets the scope and risk criteria for the remaining process.*

<sup>1</sup> Coso is the Committee of Sponsoring Organisations of the Treadway Commission

Risk criteria are the “terms of reference by which the significance of risk is assessed”. They are “based on organisational objectives, and external and internal context” and “can be derived from standards, laws, policies and other requirements”. Criteria look forward to the risk evaluation stage of the risk management process but are set when establishing the context.

### ***Preliminary risk assessment leading to a risk profile***

A risk profile must be based on at least a preliminary assessment of the risks an organisation or part of an organisation is exposed to. An effective risk assessment includes (AS/NZS ISO 31000):

- a clear understanding of the external and internal contexts of the organisation
- a process for risk identification that includes “all significant causes and consequences”
- analysis of each risk using a “process to comprehend the nature of risk and to determine the level of risk”.

Such a risk analysis will include:

- a risk description (a “structured description of risk containing four elements: sources, events, causes and consequences”)
- the likelihood of the identified consequences (the “chance of something happening”)
- the level of risk (the “magnitude of a risk expressed in terms of the combination of consequences and their likelihood” with and without current controls)
- an assessment of the effectiveness of each control (a “measure that is modifying risk” and includes “any process, policy, device, practice, or other actions which modify risk”)
- stakeholder risk perceptions (ie, the “the stakeholder’s view on a risk” where a stakeholder is a “person or organisation that can affect, be affected by, or perceive themselves to be affected by a decision or activity”).

Following the risk assessment, the risk profile can be developed showing categories or classes of risks and how they might impact on organisational objectives. A report to internal or external stakeholders regarding the current state of each risk and its management will then enable some definition of risk appetite by stakeholders and decision-makers.

An evaluation of analysed risks may be carried out at this stage to test or validate the risk criteria. The results of the evaluation can be used to revise the criteria and as part of the risk report. This will further inform development of the risk appetite.

The risk profile is a “description of any set of risks” and can “contain those that relate to the whole organization, part of the organization, or as otherwise defined”. When reported to stakeholders it helps them develop a statement setting out the risk appetite for either the whole or parts of the organisation.

### ***Using the risk appetite statement***

Knowing its risk profile, an organisation can now answer the questions:

*Are we prepared to pursue, retain or take this type of risk?*

*If so, how much of this type of risk are we prepared to pursue, retain or take?*

It is often preferable to answer these questions qualitatively but some quantitative limits might also be set.

The problem with a formal risk appetite statement is it can create a false sense of security. A novel type of risk may not merit consideration if it is of a type not covered by the statement.

### ***Which stakeholders?***

This requires use of an influence/importance analysis of stakeholders. Consulting key stakeholders will require techniques such as interviews, focus groups and surveys.

### ***Advantages of a risk appetite statement***

A risk appetite statement can help an organisation ensure the following.

Any risk acceptance is an “informed decision to take a particular risk” or treat a risk by “retaining the risk by choice”.

Employees and contractors have an agreed risk attitude (the “organisation’s approach to



assess and eventually pursue, retain, take or turn away from risk”).

It has a commonly-held risk aversion (the “attitude to turn away from risk”).

Decisions to apply risk avoidance (an “informed decision not to be involved in, or to withdraw from, an activity in order not to be exposed to a particular risk” are also commonly held across the organisation.

Risk tolerance (the “organisation’s or stakeholder’s readiness to bear the risk after risk treatment in order to achieve its objectives”) is part of business decision-making.

A risk appetite statement may also aid evaluation of a risk.

### **Some further readings**

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