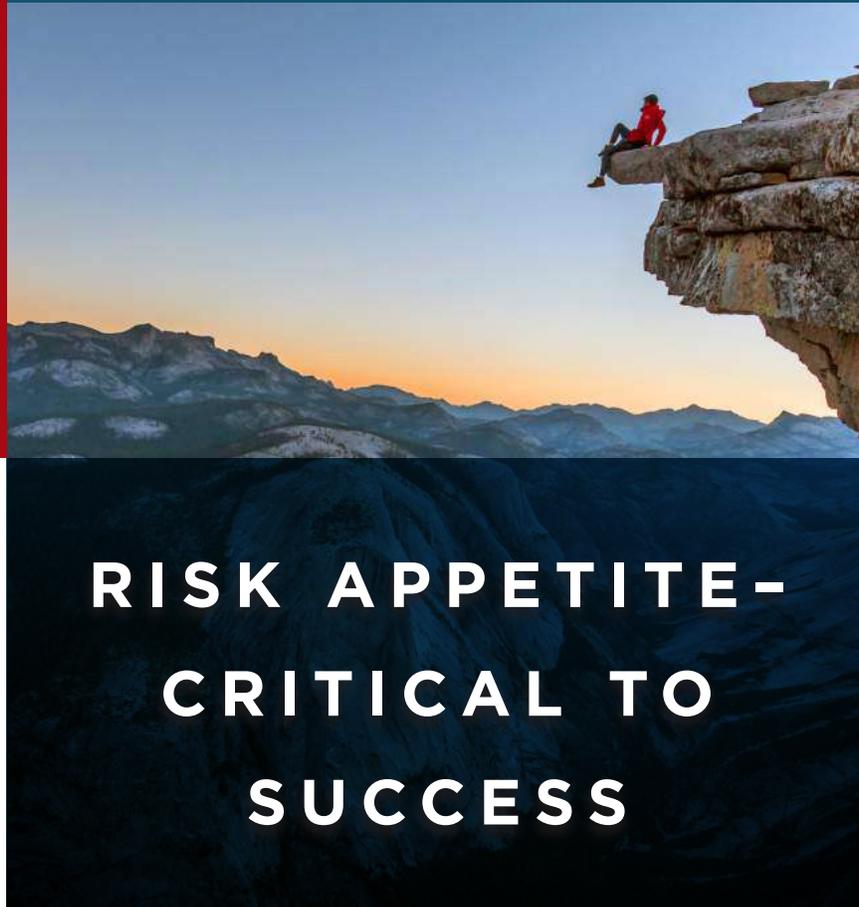




Committee of Sponsoring Organizations of the Treadway Commission

Thought Leadership in ERM



RISK APPETITE- CRITICAL TO SUCCESS

USING RISK APPETITE TO THRIVE
IN A CHANGING WORLD

By

Frank Martens | Dr. Larry Rittenberg

The information contained herein is of a general nature and based on authorities that are subject to change. Applicability of the information to specific situations should be determined through consultation with your professional adviser, and this paper should not be considered substitute for the services of such advisors, nor should it be used as a basis for any decision or action that may affect your organization.

Authors



Frank J. Martens, CPA
Pacific Rim Risk
Management Services Ltd.



Dr. Larry Rittenberg
Ernst & Young Emeritus Professor of Accounting at the
University of Wisconsin-Madison School of Business

Acknowledgements

We would like to recognize the COSO Board: Paul J. Sobel (Chair), Richard F. Chambers (IIA), Bob Dohrer (AICPA), Daniel C. Murdock (FEI), Douglas F. Prawitt (AAA), Jeffery C. Thomson (IMA) for their support of our work.

COSO Board Members

Paul J. Sobel
COSO Chair

Daniel C. Murdock
Financial Executives International

Douglas F. Prawitt
American Accounting Association

Jeffrey C. Thomson
Institute of Management Accountants

Robert D. Dohrer
American Institute of CPAs (AICPA)

Richard F. Chambers
The Institute of Internal Auditors

Preface

This project was commissioned by the Committee of Sponsoring Organizations of the Treadway Commission (COSO), which is dedicated to providing thought leadership through the development of comprehensive frameworks and guidance on enterprise risk management, internal control, and fraud deterrence designed to improve organizational performance and governance and to reduce the extent of fraud in organizations. COSO is a private-sector initiative jointly sponsored and funded by the following organizations:



American Accounting Association (AAA)



American Institute of CPAs (AICPA)



Financial Executives International (FEI)



The Institute of Management Accountants (IMA)



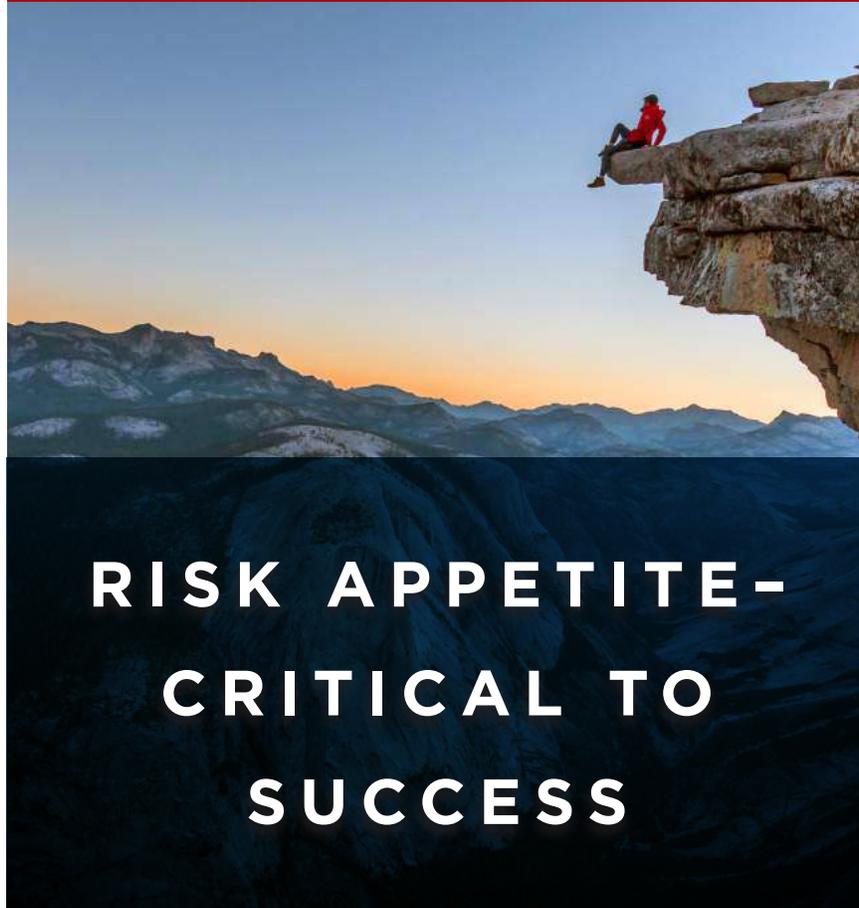
The Institute of Internal Auditors (IIA)

COSO

Committee of Sponsoring Organizations
of the Treadway Commission

coso.org

Thought Leadership in ERM



RISK APPETITE- CRITICAL TO SUCCESS

USING RISK APPETITE TO THRIVE
IN A CHANGING WORLD

Research Commissioned by



Committee of Sponsoring Organizations of the Treadway Commission

May 2020

MESSAGE TO BOARD MEMBERS, CHIEF EXECUTIVES, AND SENIOR MANAGEMENT

Why should you spend time worrying about risk appetite? Many think that it is something that board members, chief executives, and senior management intuitively know, or work out while making decisions. They may even think they don't need another document on the topic. We disagree. We need to make risk appetite an integral part of decision-making.

This document focuses on developing strategies and objectives and managing your organization for success, given the amount of risk you are willing to, and need to, take for success. What is important here is to recognize that the choice of strategies and objectives requires an understanding of appetite for risk.

This is becoming more difficult as business landscapes are changing, and we see further challenges ahead. There are more voices impacting organizations in new ways. Regulators are broadening their reach into data privacy and security, stakeholders are expecting companies to share strong social purpose, and employees are shifting the way they work. The risks associated with the changing landscape differ based on strategic directions, and these messages must be understood.

Often, approaches that react to what's going on have somewhat limited appeal. Boards and management need to become anticipatory—to listen to these voices and make decisions that are mindful of those views. Those who are able to anticipate and understand their risk when change happens are better able to embrace change and be more agile in challenging conditions.

We believe that risk appetite is a critical link between forming strategy and realizing performance. Our goal, consequently, is to help boards, executives, and managers improve their strategy setting and performance by showing them how they can more effectively apply risk appetite.

We're confident that your appetite for risk will change over time as your strategies evolve. We encourage you to exercise your governance responsibilities and explore how your executive team is applying appetite to successfully create and protect the value of your enterprise and enhance relationships with your stakeholders.



Frank J. Martens



Larry E. Rittberger



Copyright © 2020, Committee of Sponsoring Organizations of the Treadway Commission (COSO).
1234567890 PIP 198765432

COSO images are from COSO Enterprise Risk Management – Integrating with Strategy and Performance.
©2017, The Association of International Certified Professional Accountants on behalf of Committee of Sponsoring Organizations of the Treadway Commission (COSO). COSO is a trademark of The Committee of Sponsoring Organizations of the Treadway Commission.

All Rights Reserved. No part of this publication may be reproduced, redistributed, transmitted or displayed in any form or by any means without written permission. For information regarding licensing and reprint permissions please contact the American Institute of Certified Public Accountants, which handles licensing and permissions for COSO copyrighted materials. Direct all inquiries to copyright-permissions@aicpa-cima.com or AICPA, Attn: Manager, Licensing & Rights, 220 Leigh Farm Road, Durham, NC 27707 USA. Telephone inquiries may be directed to 888-777-7077.

Design and production: Sergio Analco.

Contents	Page
Introduction	1
Putting Risk Appetite into Context of the Business	3
Linking Risk Appetite and Strategy	6
Inputs to Appetite and Their Application: An Overview	8
Inputs to Risk Appetite	9
Developing Risk Appetite to Support Strategy and Objectives	14
Articulating and Communicating Risk Appetite to Support Decision-making	17
Using Risk Appetite to Enhance Performance	19
Supporting the Use of Appetite	24
Final Thoughts	25
Appendix A: Appetite and Enterprise Risk Management—Integrating with Strategy and Performance	26
Appendix B: Summary of Key Tasks	28
About the Authors	29
About COSO	30

INTRODUCTION

At its core, risk appetite is critical to organizational success. Articulating risk appetite for your organization will provide board members and senior management with important insight. We hope to improve that understanding and promote risk appetite as an integral part of decision-making.

The COSO *Enterprise Risk Management—Integrating with Strategy and Performance*¹ defines risk appetite as:

The types and amount of risk, on a broad level, an organization is willing to accept in pursuit of value.

Inherent in this definition are several key points. Risk appetite:

- Is intentionally broad to apply across an organization, recognizing that it may differ within various parts of the organization while remaining relevant in changing business conditions.
- Focuses on risk that needs to be taken to pursue strategies that enhance long-term success.
- Recognizes that risk is more than individual decisions.
- Links to value—it is tied to the choices the organization makes on how it creates and preserves value.

This thought paper is intended to help directors and executives answer the following question:

How will a better understanding and communication of risk appetite help our organization succeed?

Six Things to Remember about Risk Appetite

1

RISK APPETITE IS NOT A SEPARATE FRAMEWORK

It is integral to managing risk and integral to how organizations communicate and act. Managing risk within appetite should not be treated as a stand-alone activity, but as part of a portfolio of risks to be articulated and addressed through the organization.

2

RISK APPETITE AND RISK TOLERANCE DIFFER

Various documents use the terms “risk appetite” and “risk tolerance” in different ways, even interchangeably. This adds to the confusion in understanding their meaning. Though related, they are different ideas.

3

RISK APPETITE APPLIES TO MORE THAN THE FINANCIAL SERVICES INDUSTRY

It is embodied in many financial service regulations, but can help all organizations to better understand and manage performance.

4

RISK APPETITE IS AT THE HEART OF DECISION-MAKING

It is germane to decision-making. It is equally important in determining that a decision is necessary.

5

RISK APPETITE IS MUCH MORE THAN A METRIC

Often, it is treated as part of an approach where each metric is assigned a target appetite. Although such an approach is important, a better application of risk appetite can lead an organization to proactive, forward-looking opportunities that tie appetite and strategy together for future action.

6

RISK APPETITE HELPS INCREASE TRANSPARENCY

A well-formed and communicated risk appetite provides awareness of the risks the organization wishes to assume as well as those it wishes to limit.

¹ *Enterprise Risk Management-Integrating with Strategy and Performance*, referred to in this paper as the *Framework*

This paper is structured into the following sections:

- 1 Putting Risk Appetite into Context of the Business—** Focuses on how organizations take on risk to innovate and grow, and shows that appetite must be flexible enough to adapt to changing conditions, helping an organization to remain relevant in an evolving landscape.
- 2 Linking Risk Appetite and Strategy—** Emphasizes the importance of understanding strategy and objectives and that taking risks requires a sense of the type and amount of risk acceptable and necessary in pursuing strategies and objectives. It explores a key difference in adopting an objective-focused and a risk-focused approach.
- 3 Overview of Inputs to and Application of Risk Appetite—** Provides an overview of how risk appetite is applied in the context of strategy and objectives, developed to support decision-making, and used to enhance performance. Each of these points is developed in the following sections.
- 4 Inputs to Risk Appetite—** Considers the inputs that affect how risk appetite is applied. Among the more important are the organization's mission and vision, board and management perspectives on appetite, the current strategy to pursue value, risk profile, and culture.
- 5 Developing Risk Appetite to Support Strategy and Objectives—** Considers how an organization develops risk appetite in the context of overall strategy, and how it incorporates risk appetite into objective-setting. This section explores how organizations may use different approaches to build consensus and encourage more consistent decision-making.
- 6 Articulating and Communicating Risk Appetite to Support Decision-making—** Considers how an organization can clearly and consistently articulate risk appetite to enhance decision-making, especially when boards and management may not agree. Being able to clearly communicate appetite improves when there is a commonly applied structure, one that considers the choice of language, the intended level of precision, and a focus on strategy and objectives rather than risks.
- 7 Using Risk Appetite to Enhance Performance—** Considers how risk appetite is used to develop tolerance, measures, and indicators, and to monitor performance in day-to-day practices.
- 8 Supporting the Use of Appetite—** Offers our views on what organizations need to do to sustain risk appetite as part of an effective approach for enterprise risk management.
- 9 Final Thoughts—** Wraps up our views that successful organizations take risk to succeed.



PUTTING RISK APPETITE INTO CONTEXT OF THE BUSINESS

Every organization must accept that taking risks to innovate and grow is inherent to business. To not do so leaves the organization vulnerable to losing ground to other competitive organizations. The challenge is to know the right amount of risk necessary to sustain innovation and growth across the organization. With that knowledge, an organization can determine which strategies to adopt and which objectives to pursue.

Risk appetite must also be flexible enough to adapt to changing conditions, helping an organization to remain relevant in the evolving landscape. For example, during good economic times, a successful and growing company may be more willing to accept certain downside risk than when economic times are bad and business outlooks deteriorate. Early applications of risk appetite often focused on financial and operational measures. This focus worked well with a compliance mindset. But to excel in applying appetite, organizations need to broaden their scope, which requires viewing enterprise risk management through the lens of objectives that align with performance expectations. This view expands risk appetite to include all stakeholders, and to being incorporated into the organizational culture.

Such a view can be articulated in a statement on how an organization intends to make decisions in managing risk. A sample statement might be as follows:

We will pursue innovation to improve customer service and efficiency in operations unless such innovation potentially elevates risk relating to internal capabilities or creates risk of significant disruption to business operations. Innovation that creates significant risk about ongoing financial performance will be considered where regulatory compliance risks are unacceptably high.



The Case for Risk Appetite

In 2019, one of the largest medical equipment companies failed to identify a major flaw in the software included in an updated product used to supplement a doctor's analysis. The equipment was designed to look like existing products, and the software update was intended to allow users to acclimate quickly to the updated product. Unfortunately, the updated software failed on a low percentage of cases, with the possibility of causing harm—even loss of life.

Clinical testers assessing the updated product did not extensively test the software, even though a few failures were noted while the product was in development. A fast rollout of the product was important to management and the board to beat competitors to market with this updated product.

What went wrong?

One might say that the company didn't understand the type of risks, or that the risk of failure was very low, or that time in developing and using appetite in this context would not be beneficial. Others might say that having the board address appetite would be too far removed from actual risks, and that such discussions would be more "lipstick" than "substance."

Like many organizations do, this one missed the opportunity to discuss what and how much risk should not only be accepted, but taken on, in pursuing its objective of successfully bringing this updated product to market.

In addition, there was a question about understanding how the company's risk appetite was changing. For example, the company had been underperforming on the stock market. It had moved its headquarters to a new region of the country to an area with a strong financial center while leaving its product development group in a part of the country with strong engineering resources. The board decided to enhance share value by a massive share buy-back program. This led to higher earnings per share, but it also moved the company away from its engineering and innovation heritage. Bottom line: the company's risk appetite was changing, in fact increasing, as the company sought to improve shareholder returns.

How could a more comprehensive view of objectives and risk help?

There are many ways to look at the objectives and associated risk the medical equipment company faced. For example, there was the risk of financial penalties if the medical equipment was not delivered on time, creating uncertainty over the ability to meet financial performance objectives. There was a tension between lowering the risk to product accuracy and improving financial rewards to deliver on time and cement the future with a reputation for innovation and quality. At the same time, capabilities for innovation were waning. Further, stakeholders, engineers, doctors and patients may have a different view of what constitutes an acceptable risk.

Would a better articulated risk appetite have helped this medical company? The answer is an unequivocal yes.

What can we learn from this?

There are several important lessons to learn from our medical equipment company.

- 1 It is easy to second guess a risk that occurred, even one viewed as having a low likelihood. Sometimes risks viewed as having a low likelihood do occur, but that may not mean that the appetite was wrong or that decisions were flawed. What was important was that management needed to be diligent in assessing its ability to bring this updated product to market, with few consequences to the company's reputation and brand.
- 2 A well-constructed narrative providing guidance for decision-making would have helped in this situation. It would have provided clarity to those making decisions and confidence to those responsible for overseeing that decisions reflect the board and management collective views on risk. It would also provide transparency to others wanting to better understand risks viewed as within appetite.
- 3 Having a clear risk appetite would have provided a better understanding of whether the risks in bringing this product to market were within management's comfort level, or whether, collectively, they exceed the acceptable amount of risk.

The role of appetite in enterprise risk management

Appetite is only one part of enterprise risk management—one that does not operate in isolation. As set out in the *Framework*, appetite flows through all aspects of enterprise risk management.² It needs to integrate with other parts of the business, from strategy development to implementation and monitoring.

This document reinforces the views in the COSO Framework by emphasizing that:

- Organizations must understand the changing business context and how the organization reacts to those changes.
- The amount of risk the organization is willing to take is something that the C-suite and board should know when selecting strategies and objectives.
- The choice of strategy and objectives are significant factors to organizational success.
- Taking risks requires a sense of what amount of risk is acceptable in pursuing strategies and objectives, balancing the relationship of risk and reward.
- Choosing the status quo constitutes a risk that management must also assess.
- Risk appetite need not be about quantification.

Clarifying Some Language

RELATIONSHIP BETWEEN STRATEGY AND OBJECTIVES

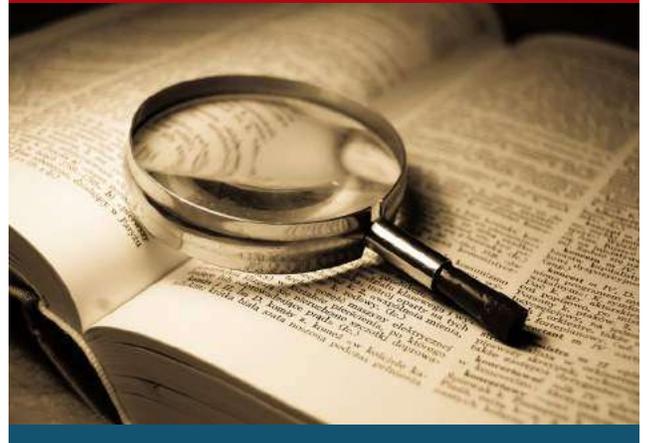
Strategy is the organization's plan to achieve its mission and vision and apply its core values to drive performance and value. We hold the view that strategy precedes objectives. It follows, then, that strategy is directly linked to the decisions about how an organization creates value. Objectives are those measurable steps an organization takes to achieve its strategy. Objectives cascade to the entity's business units, divisions, and functions.

RELATIONSHIP BETWEEN OBJECTIVES AND TOLERANCE

Tolerance refers to the boundaries of acceptable variation in performance relative to objectives. We view tolerance through a performance lens, aligning it with performance measures used for objectives, not risk. This is further explored in Appendix A.

RELATIONSHIP BETWEEN RISK PROFILES AND PORTFOLIO VIEW

Both **risk profiles** and **portfolio view** refer to a composite view of the risk that may affect performance relative to the strategy and objectives. A **portfolio view** is more encompassing, because it is entity-wide, and **risk profiles** may be at any level of the entity.



² Appendix A provides an expanded description of *Enterprise Risk Management—Integrating with Strategy and Performance* and how appetite is depicted in the Framework.

LINKING RISK APPETITE AND STRATEGY

An organization should expect that the strategy it selects will be able to be carried out within the entity's appetite; that is, strategy must align with appetite. If the risk associated with a specific strategy is inconsistent with the entity's appetite, it needs to be revised, or an alternative strategy needs to be selected, or the appetite itself needs to be revisited.

For instance, a sports equipment manufacturer had this strategy: "To grow business by expanding global manufacturing locations." However, when it became clear

that some global locations presented risk that exceeded the manufacturer's appetite, the strategy was updated: "To grow business by expanding to global locations within established infrastructure requirements and governmental regulations."

The development of risk appetite should align with the development of strategy and business plans, otherwise it may appear that views on strategy and risk appetite are conflicting.

Figure 1. Strategy in Context



Source: COSO Enterprise Risk Management—Integrating with Strategy and Performance

The Framework sets out three important views on the relationship of enterprise risk management and strategy. Each view is relevant to the discussion on risk appetite.

- **Possibility of misaligned strategy and business objectives**—Both mission and vision provide a high-level view of the acceptable types and amount of risk for the entity. They help the organization to establish boundaries and focus on how decisions may affect strategy. An organization that understands its mission and vision can set strategies that will yield the desired portfolio view of risk.
- **Implications from the strategy chosen**—Enterprise risk management does not create the entity's strategy, but it informs the organization on risks associated with alternative strategies considered and, ultimately, with the adopted strategy. The organization needs to evaluate how the chosen strategy could affect the entity's overall portfolio view of risk, specifically the types and amount of risk to which the organization is potentially exposed.
- **Risks to strategy and performance**—There is always risk in carrying out a strategy. The focus is on understanding the strategy set out and what the risks are to its relevance and viability. Sometimes the amount of risks become important enough that an organization may wish to revisit its strategy and consider revising strategy to one with a more suitable risk profile. New types of risks may also emerge as the organization executes its strategy. The risk to carrying out strategy is best viewed through the lens of objectives.

Objective-focused approaches

Objective-focused approaches are closely tied to strategy direction and how an organization intends to create value. They focus on entity-level goals and priorities.

The following are some examples of objective-focused statements:

- **Energy company**—We will pursue innovation to improve customer service levels and efficiency in operations unless such innovation potentially elevates safety concerns or creates significant disruption to business operations (objective: to innovate to create value).
- **Industrial products company**—We will seek ways to offer a diverse suite of products that offer equipment of superior quality and reliability. We understand that such goals may come with a cost. We will prudently accept risks that increase our costs when doing so is needed to maintain quality (objective: to produce superior and reliable products).

In developing an objective view, organizations need to understand the overall risk profile relative to those objectives and, ultimately, the overall strategy.

Risk-focused approaches

In contrast, most often risk-focused approaches can be tied to the risk or categories of risk noted in a typical risk register—risks of losing staff, loan concentrations, warranty

costs, patient’s seen, etc. Risk-focused statements often complement the broader objectives-focused approach by articulating, more precisely, the expected outcome. The following are some examples:

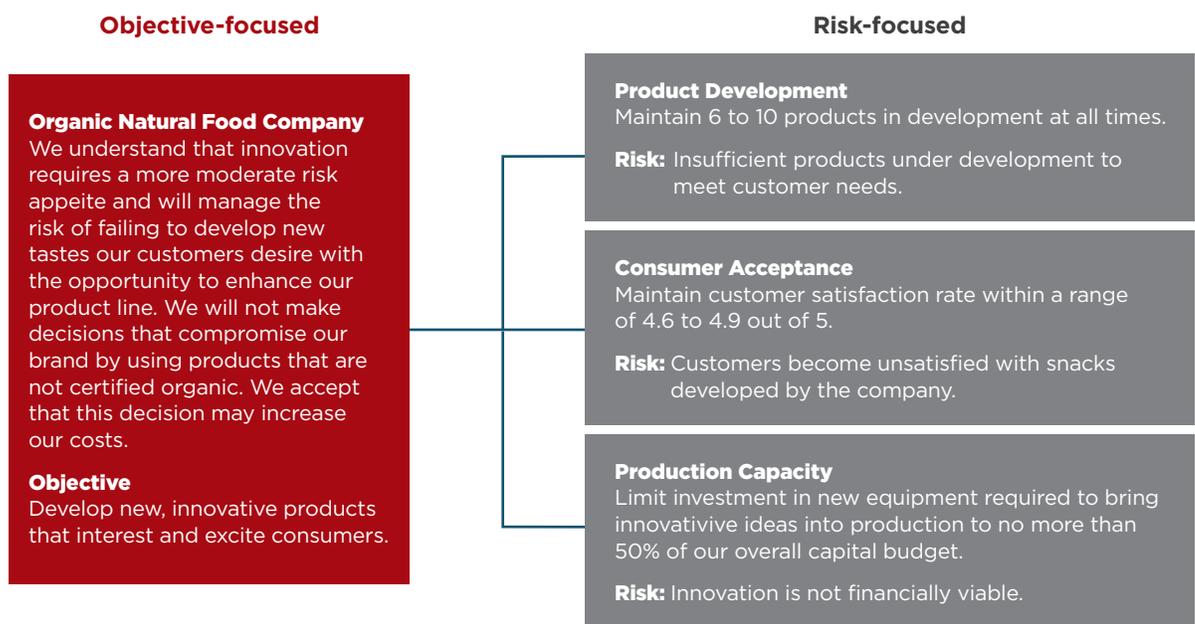
- **Automotive company**—Maintain number of new vehicles requiring warranty repairs within a range of 1% to 2% (risk: warranty costs).
- **Community bank**—Maintain exposure to geographic concentrations in any one region to 20% of the overall portfolio (risk: credit losses).
- **Hotel management company**—Maintain staff turnover levels at less than 60% on an annualized basis (risk: losing staff).

We suggest organizations adopt an objective-focused approach, which cascades into risk considerations, unless there are specific regulatory or other business reasons limiting this choice.

Linking the approaches

An organization may choose to adopt an objective-focused approach and cascade those objective-based appetite statements into risk-focused statements, as the figure below illustrates.

Figure 2. Linking the Approaches

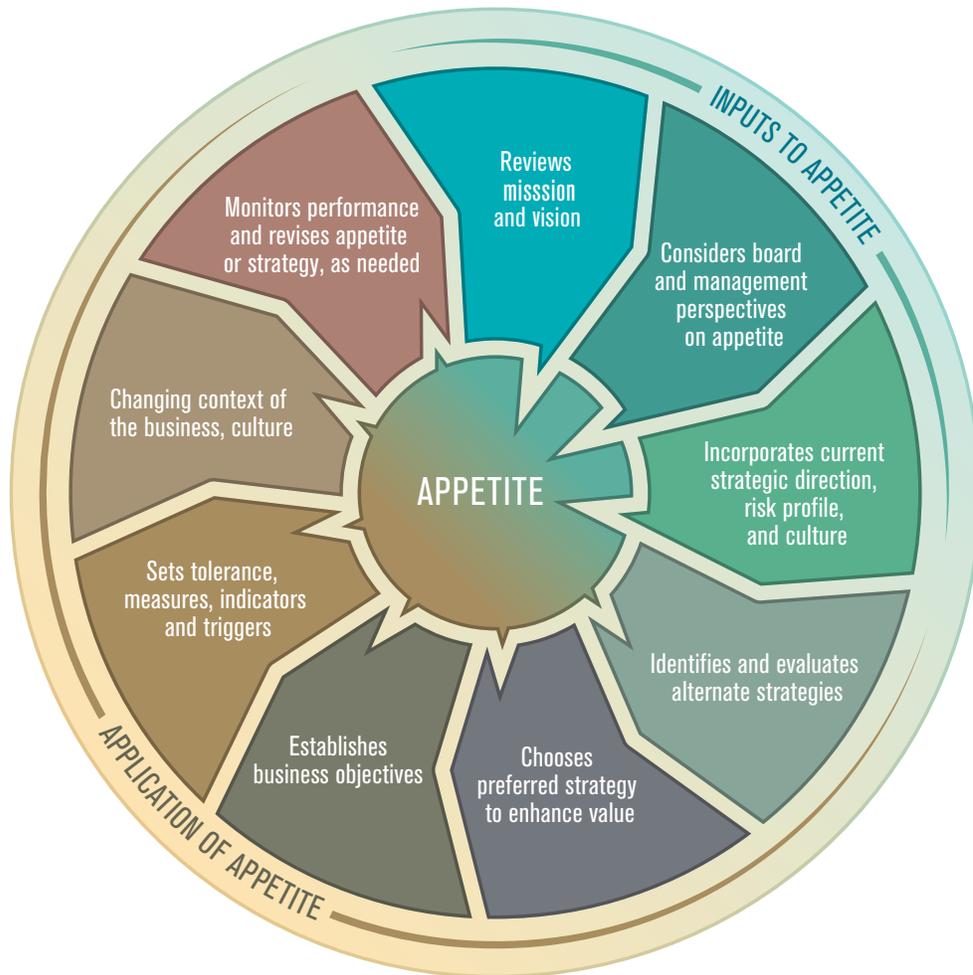


INPUTS TO APPETITE AND THEIR APPLICATION: AN OVERVIEW

The diagram below illustrates the cycle of appetite, from mission and vision through the selection and execution of

strategy and objectives, and feedback through monitoring performance.

Figure 3. The Continuing Approach to Developing and Applying Appetite



To apply appetite as depicted above, an organization must adopt a structure for developing, articulating, and communicating appetite. We set out four broad phases:

- 1 Inputs to appetite**—Considers those inputs that shape how appetite is applied.
- 2 Developing appetite to support strategy and objectives**—Considers how an organization develops appetite in the context of its overall strategy and incorporates appetite into the setting of objectives.
- 3 Articulating and communicating appetite to support decision-making**—Considers how an organization can develop a clear, consistent articulation of appetite that enhances the ability to make decisions, especially when boards and management may have differing views.
- 4 Using appetite to enhance performance**—Considers how appetite is used in developing tolerance, measures, indicators, and triggers, and in monitoring performance and using these in day-to-day practices.

INPUTS TO RISK APPETITE

Mission and vision

Mission and vision set out the initial views on how the organization will create value. They guide decisions on where the organization may, and may not, venture.

Risk appetite needs to align with that vision. It clarifies the nature of acceptable risk and provides greater confidence that the organization as a whole remains aligned with its overall mission and vision.

Consider, for instance, two companies. Both are in the consumer products industry and in some markets may compete with each other. Yet their respective mission statements suggest they will take on different risks.

- **Company A mission statement:** Our goal is to provide high-level service and the broadest selection of products at the most competitive prices.
- **Company B mission statement:** Our goal is to deliver the most innovative consumer products, with the best service and value, within the communities we serve. We will expand only if we have a competitive advantage and the ability to be a leading provider in new communities.

Both companies focus on products and services relevant to generating value for their stakeholders. Company B provides added context by focusing on innovative products of higher level and value. The emphasis on innovation, best value, etc. signals that the company is willing to take on additional risk to be aligned with the company's strategy.

Making decisions about selecting strategy and developing appetite is not a linear process with one decision always preceding the other. Nor is there a "right" appetite that applies to all organizations. Yet, there is an appetite suitable for each organization—one that reflects the unique mission, vision, and core values.

Risk appetite helps an organization know when decisions are diverting efforts away from the mission and vision. When that happens, the onus is on management to revisit its decisions. When necessary, the board may review the chosen strategy with management, perhaps identifying and evaluating alternative strategies.

Strategic direction

Risk appetite is a fundamental part of setting strategy and objectives, providing context as the organization pursues a given level of performance. For example, setting a goal of growing the customer base by 2% likely has a very different risk profile than growing it by 12%.

The discussion of appetite is not always about taking on too much risk. Sometimes it is about an organization becoming overly risk-averse—that is, being unwilling to accept more risk to drive performance. Revisiting the organization's appetite from time to time can help management and the board understand that the organization may need to take additional risk to thrive, or that it needs to expand, not contract. Moreover, although an organization often can adjust to take on more risk within the set appetite, there may be times where it needs to adjust appetite, or perhaps even strategy, to accommodate a shifting business environment.

The current strategic direction of the company offers valuable insight into risk and potential performance. That's because strategy development contains a series of assumptions—what an organization holds to be true when strategy is set. For example, an organization that has based its strategy on the assumption that its industry will undergo significant disruption from digital transformation may see the need for a higher appetite to be innovative and thrive in such an environment.

Further, many successful organizations focus on differentiating capabilities that underpin strategy. For one company, this may be customer service; for another, it may be technical skill and know-how that drive innovative thinking. Knowing these capabilities is important. The organization that recognizes that such capabilities drive value would likely have a lower appetite for those capabilities to erode.

Board and management perspectives on appetite

Boards and management have choices on how appetite will be applied within the organization. The organization will need clear direction from the board and management on the following:

- Whether the organization will adopt an approach that views appetite through an objective-focused lens or a risk lens, or an approach that integrates these two approaches.
- The focus on monitoring performance and decision-making.
- The focus not only on risks the organization wishes to avoid but also those it wishes to take on to enhance value.
- The extent of natural tensions needed for appetite to add depth in discussions on analysis in support of decisions.
- Stakeholder views the organization will incorporate into appetite.

Decision-making and monitoring

There are two broad ways that apply appetite. One widely used approach focuses on monitoring to provide feedback on how the organization is performing. Organizations often use appetite to form risk boundaries. A matrix showing a statement of risk, key performance measures, target, actual performance, and appetite boundaries allows management to monitor whether current risks are within appetite. Such monitoring can trigger conversations on when to revisit decisions, and perhaps appetite or strategy.

A second—perhaps more important—approach is to apply appetite in the context of decision-making. Using appetite in this context can enhance the extent of analysis and challenge of the chosen strategy and objectives as well as the organization’s ability and capacity for managing activities within the parameters of acceptable risk.

In essence, the decision-making approach is more anticipatory (considering risks that may lie ahead). This allows an organization to be more resilient to future changes and disruption. Conversely, the monitoring approach is often reactionary, responding only when the outcomes of potential risks affect impact performance. Such impacts can be mitigated somewhat by using leading indicators, but, in reality, most organizations rely mainly on lagging indicators.

Ideally, the board and management will choose to use an approach that incorporates appetite into decision-making with more detailed indicators that help monitor accepted risks.

We suggest organizations determine whether the organization will apply a monitoring approach or one that integrates decision-making and monitoring practices.³

Risk requisite for performance

Appetite often focuses largely on what to avoid and misses the important factor: that every organization takes risks to be successful. For instance, appetite may focus on areas such as the following:

- Not exceeding a credit threshold.
- Managing to a staff turnover ratio.
- Maintaining a minimum number of sales opportunities in a sales pipeline.
- Meeting supply chain requirements.



³ Key tasks are summarized in Appendix B.

Although such statements help an organization know what it should *not* do, they do not encourage decisions that reflect a level of risk needed for the desired level of performance. Boards and management should reinforce that appetite is not about making all decision-makers risk-averse, but about encouraging decisions that recognize that every successful organization takes risks. This may be done by linking risk considerations with strategy setting or by incorporating both lower and upper boundaries of risk into appetite statements.

EXAMPLE 1

Minimal levels of risk needed by a professional services firm

A regional professional services firm believes that to successfully compete in its market, it needs to grow at an annual rate of 10.5%. Historical annual growth within its region has averaged 7% and is expected to continue at that rate for the next year. The company's strategy is to focus on a core set of services within its region. A careful review of the marketing plan and workforce expansion plans estimated that these are expected to add 1% to 2% of growth over industry norms, largely by taking market from its competitors. This strategy is unlikely to attain the growth the partnership sees as necessary to compete. The partners will need to consider whether a strategy with a higher risk profile—perhaps introducing new services or expanding into new regions—is needed to achieve a 10.5% growth rate.

We suggest organizations determine whether to include both lower and upper boundaries.

Natural tensions

Natural tension refers to those situations where one appetite statement appears to support a decision while conflicting with another statement. For instance, suppose a company is willing to accept more risk to grow its customer base, but wants to keep the same gross margin while maintaining the current amount of risk to its profit margin. In this scenario,

a marketing incentive aimed at attracting new customers through deep discounts creates a natural tension between these two aims.

Natural tensions are healthy as they stimulate more robust business conversations. Analyzing statements and tensions is a key component to reaching a meaningful articulation of appetite for an organization.

EXAMPLE 2

Natural tension within a community bank

A community bank has a goal to support the community in which it operates. It also has a responsibility to its shareholders to remain financially prudent in its decisions. With that in mind, among its appetite statements, it includes the following:

- We encourage our staff to offer financial products to our customers that serve their needs, but not where the credit risk exceeds prudent levels.
- We seek to support our local community in becoming a vibrant and diverse place to live within a profitable business context.

The bank has been asked to fund a loan to the local food bank to help it upgrade its premises to better serve the community. In considering this request, management looked at the ability of the food bank to service the loan, specifically because it is highly dependent on donations, which can vary as social values and behaviors change. Further, they questioned what secondary source of security would exist if the food bank's revenue stream was not sufficient. Would the community bank be prepared to foreclose on a loan that caused people to go hungry? Yet, the community bank was clearly prepared to take risk to support the local community. Does the risk of financial loss from a poorly performing loan outweigh the risk that comes from not supporting the local community and developing a strong business context in that sector? The natural tension within these appetite statements helps stimulate a deeper business conversation.

We suggest organizations consider the extent to which natural tension will be designed into risk appetite.

Stakeholder views

Boards and management often consider appetite in relation to only a few stakeholders—typically shareholders and regulators. That view is limited.

Stakeholders come in various guises, but all have a vested interest in the entity. Some, such as a majority shareholder or regulator, may be able to exert their view of the entity. Others, such as minority shareholders and customers, may exert indirect pressure by shifting their investments and loyalties to other entities. Yet other stakeholders, such as communities and interest groups, exert pressure by influencing those that affect the entity.

Stakeholder activism can become more vocal when stakeholders view actions as outside their boundaries of acceptable risk, at times going so far as impacting the reputation, brand, and trust in the organization.

EXAMPLE 3

Competing stakeholder views

A consumer product company is considering a change to its packaging to reduce shipping costs. The company currently ships its product in cardboard boxes. Management is considering the following three options:

1. Switch to a cheaper disposable plastic packaging, which is both lighter and smaller.
2. Switch to packaging with a higher post-consumer recycled content, recognizing that the package is both heavier and larger.
3. Retain the current packing.

There is a natural tension in place but, unlike the example of the community bank, here the company must consider different stakeholders. The shareholders may prefer the most cost-effective option, as there is a lower risk to financial performance, but the broader public may prefer the second option as it helps to reduce the environmental footprint of the company and considers environmental, social, and governance matters. Management will need to weigh these opposing views in making its choice. Perhaps, more importantly, the detailed discussion can lead to innovative solutions. For example, many organizations opt for new alternatives as they do not like the risk in any of the three options, they are too expensive, and stakeholders want the organization to help save the planet, and the risk of not being an environmental partner is considered to be high.

Understanding the existing risk profile

Appetite is not developed in isolation from other factors. For instance, management should consider its existing risk profile not as a determinant of appetite, but as an indication of the risks the organization currently addresses and might reasonably foresee in the future.

Added context may relate to the external environment (competitive, economic, environmental, legal, political, social, technological, etc.) and the internal environment (capital, people, process, technology, etc.).

The board and management may use these characteristics when setting appetite to ask questions such as the following:

- Are we setting an appetite that needlessly hinders our capacity for change?
- Are our practices and culture aligned with our appetite with an emphasis on thriving in a changing world?
- Would alternative strategies requiring a different appetite (higher or lower) significantly impact performance?
- Do we believe that our appetite will result in the desired risk profile?

There may be other factors to consider as well. Management should tailor those noted here, removing considerations less relevant and augmenting those with other considerations.

We suggest organizations consider the organization's unique business context when setting risk appetite.

EXAMPLE 4

Consideration of changing business conditions

A newspaper decided that the risk of becoming irrelevant in the news arena was so large that it developed a strategy that essentially “bet the company” on developing a new digital channel for delivering news to its viewership. If the strategy had been unsuccessful in anticipating changes in readership habits, its subscription base would likely fall to uneconomic levels. The risk was high, but it was understood by all involved in the process.

The board was well aware of the risks relating to this strategy, having debated the issue extensively, and it concurred with management's decision (an acknowledgment of the linkage of strategy and appetite). The investing public was also aware of them because both the strategy and nature of the risks (the impact on stock prices) had been communicated to them. It's notable that the strategy was carefully debated, and the company was going to succeed or die quickly—as opposed to an almost certain slow death if it did not take on risk through an aggressive strategy.

Culture

For many organizations, applying appetite requires a culture that is aware of strategy, objectives, and risk. Management, by revisiting and reinforcing appetite, is in a position to create a culture in which organizational goals are consistent with the board's goals, and to hold those responsible for managing risk within acceptable appetite.

Many organizations are good at creating a risk-aware culture—one that emanates from senior management, cascades through the organization, and is supported by the board. With an effective culture, each member of the organization is clear on what is acceptable and what is not, whether in relation to behaving unethically, pursuing the wrong objectives, or encountering too much risk in pursuing the right strategies and objectives.

Creating a risk-aware culture is important in reinforcing appetite to achieve the following:

- Consistency between appetite, strategy, objectives, and relevant reward systems.
- Consistent understanding of appetite and related tolerances for each organizational unit.
- Consistent implementation across units.
- Understanding of changes in appetite.

We suggest organizations capture key inputs and consider how to incorporate them into risk appetite (e.g., mission and vision, current strategic direction, risk profile, and culture).

DEVELOPING RISK APPETITE TO SUPPORT STRATEGY AND OBJECTIVES

How can an organization bring out the implicit feelings that the board and management may have about what they believe is the organization's appetite and how discussion of those views leads to development of appetite?

Management and boards often use one or more approaches to develop their appetite. These include facilitated discussions related to mission and vision, discussions related to strategies and objectives, and analysis of performance.

We suggest organizations develop an approach that includes facilitated discussions related to mission and vision, discussions related to strategies and objectives, analysis of performance, or other approaches preferred by the organization.

Facilitated discussions

Facilitated discussions can be very effective for a variety of organizations. These sessions are most often led by the person tasked with supporting the overall use of appetite, often at a senior level.

Sample questions for discussion may include the following:

- 1 Can you describe activities that would, in your view, be above our appetite and how might these relate to our strategy?
- 2 Can you describe activities that would, in your view, indicate the organization isn't taking enough risk to attain the performance it wants?
- 3 Are there aspects of our business that have a lower or higher appetite for risk? Why?
- 4 Which strategies or objectives are most important to our success? Do you view appetite differently for those strategies or objectives?
- 5 Where do you think our risk appetite is today? Is it averse, neutral, or aggressive? Do you think it should be higher or lower in the future to sustain success?
- 6 Are there specific risks that need to be considered in developing our appetite? Which ones and why?

After several iterations, management can develop appetite statements that reflect the combined views of the board and management.



This approach encourages management and the board to clearly prioritize objectives and associated appetite. In addition, various scenarios can be discussed to explore how the appetite would influence decision-making throughout the organization.

The possible disadvantage of this approach, however, is that it may capture only some views from across the entity as there are often resource constraints limiting the number of people who directly engage. It may also be challenging to manage bias, which requires an adept facilitator.

We suggest organizations keep the organization's strategic plan, including mission and vision, at the forefront of facilitated discussions on appetite. Avoid biasing discussions toward only one or two lines of the business.

Discussions related to strategy and objectives

Appetite often becomes more evident when management considers major issues facing the organization, such as innovation, new product lines, acquisitions, or joint ventures. Organizations with a lower appetite will usually react differently to innovation, acquisition, expansion, competition, and market volatility than those with a higher appetite. Reviewing and assessing these reactions can provide insight into the organization's current appetite. Integrating considerations of appetite with strategic planning will likely provide the most timely understanding of the type and amount of risk sought by the board and management.

Appetite statements can also help to form the boundaries that keep the organization focused on strategy and discouraging sometimes subtle but important decisions that pull the organization off course. Having clarity on appetite assists the board in having healthy discussions that challenge management's depiction of appetite. In turn, management gains a sense of the board's appetite for specific strategies that can be incorporated into a risk management process. These boundaries can also help hold management back from chasing fads.

It is, however, usually a mistake to focus only on senior levels of management and overlook those engaged in day-to-day activities.

We suggest organizations include in the development of appetite both senior levels of management and those engaged in day-to-day activities.

Developing performance contexts

Some organizations use quantitative measures to express appetite. They may arrive at these measures through business modeling. With the increasing availability of data and data analytic tools, organizations may develop data-rich contexts that provide insight into the impact of various strategic and operational decisions on entity performance.

For instance, an organization may focus on its production cycle. The focus might identify the current production path and key quality assurance points and consider the effect of product rework on time and cost. At an operational level, management may use the context to assess decisions on improving production time through innovation or by eliminating quality assurance points. At a more strategic level, the context might be used to assess how introducing a new product line would affect overall production time and cost. Understanding appetite helps when considering how these decisions may be viewed in terms of the overall risk relating to timely product production and quality.

The proliferation of data and evolution of technology has allowed for greater use of modeling and analytics at a more reasonable cost. However, there are usually business goals—and risks—that are difficult to quantify with precision. For that reason, modeling is typically just one part of the process of developing appetite.

We suggest organizations debate and discuss with management and the board the levels of risk that seem too high or low.

Validating appetite

There may be a sense that these discussions of business modeling or other approaches will produce a complete view of appetite. Often, however, that view is based on what people believe the organizations should, or will, act on when considering risk in decision-making.

One insightful approach to validating appetite is to apply the statements to a series of past decisions—in essence, back-testing the statements or boundaries in place. Organizations may also choose to back-test assumptions, such as those on how the business environment informs performance. This approach may reveal instances where decisions were made outside the intended guidance. There may have been certain board or management judgments that considered the strategic opportunities available and led to a conscious decision to shift operations either above or below its normal appetite. In addition, those making the decisions may have been displaying a form of bias if there were cultural factors that influenced those decisions.

The boundaries set can also be compared to historical performance to understand the guidance offered in these measures. Some organizations review measures from peer companies and industries to see if they have adopted an appetite that varies greatly from others. Some variation in appetite is typical as companies have different missions and visions and may have adopted a strategy that requires a higher or lower appetite to remain resilient to those changes.

It's also worth looking at emerging trends and considering whether appetite is sufficiently accommodating to them. Taking a “what if” approach to assumptions about the future may reveal internal biases that emerged during the development of appetite. For example:

- What if key talent needed to sustain growth is not available or not engaged?
- What if the actual rate of innovative ideas pursued exceeds our expectations?
- What if new business disruptors enter the market sooner than expected?

Each of these approaches may instill in management the need to refine appetite to provide added insight for decision-making.

We suggest organizations develop a plan to validate risk appetite, using the approaches developed within your organization.

ARTICULATING AND COMMUNICATING RISK APPETITE TO SUPPORT DECISION-MAKING

Once an overall risk appetite is developed, management must then choose a mechanism for communicating it. The clarity of communicating appetite improves when there is a commonly applied structure, one that considers the choice of language, the intended level of precision, and preferably a focus on strategy and objectives rather than risks. Regardless of approach, appetite does need to flow from the board down through senior management, middle management, operational leaders, and staff.

Each organization should determine the best way to communicate appetite to operational leaders in a manner specific enough to provide clarity to those tasked with monitoring whether risks are being managed within appetite. Although those in a risk role will often use risk-specific terminology, communication styles need to resonate across stakeholder groups and at varying levels within the organization.

To be effective, appetite must be:

- Operationalized through appropriate tolerances, and where necessary, codified through policy
- Stated in a way that assists management in decision-making
- Precise enough to be useful in making decisions and in monitoring by management and others responsible for managing risk
- Applied by those with decision-making authority from the board through senior and middle management on down into the entity

We suggest organizations adopt language that resonates with both the stakeholder group and at varying levels within the organization.

Precision in appetite statements

Appetite statements often start out broadly, perhaps with a single overarching statement, followed by more precise statements that cascade into tolerance statements relevant to operations across the organization. Some organizations find that broad statements crafted around terms such as “low,” “medium,” or “high” appetite are sufficient for their needs.

Of these terms, “medium” is often the most challenging. Many simply interpret it to mean as “more than low and less than high,” often leaving appetite statements lacking clarity unless there is added context.

That’s why organizations are encouraged to add context to the broad terms, for example,

Echo Relief, a service organization to help people through disasters, will pursue new programs that enhance the delivery of services to those in need within our financial ability. We will accept moderate risk to the safety of staff and volunteers as we respond to disasters. In order to maintain good stewardship of donor funds, we have a low appetite for risks related to misuse of funds.

Others will develop more precise appetite statements, such as,

We are not comfortable accepting more than a 10% probability that we will incur losses of more than \$1 million in pursuit of a specific objective.

Deciding which type of appetite statements are best is up to management. Stakeholders, however, prefer risk statements that are not generic, but rather refer to how management and the board run the organization. Often, as organizations become more experienced and their risk management capabilities mature, their appetite statements become more precise.

We suggest organizations view the current level of precision in their appetite statement and ask if it has evolved as overall risk management capabilities have matured.

Choice of language

The choice of language and length of an appetite statement will vary by organization. Some statements require several sentences to express how much risk is both necessary and acceptable, while others may be more succinct and still clearly communicate management’s appetite for risk. The aim is to balance brevity with clarity.

In developing a statement, the organization should ensure that appetite is sufficiently stated so that it can be communicated to a variety of stakeholders and to those at various levels within the organization.

Wherever possible, develop these statements using language that mimics that used for strategy and objectives. If the strategy is structured using plain language, adopt the same approach for appetite. If the strategy is a one-page infographic, adopt a similar visual guide for appetite. Doing so helps preserve cultural norms within the organization.

We suggest organizations use language that mimics that used for strategy and objectives.

Aligning appetite with business taxonomy

Most organizations have an existing taxonomy (language) they use as part of their enterprise risk management practices. Management may develop categories for strategic priorities, objectives, and various types of risk, which can be leveraged when articulating appetite. Whether an organization applies a monitoring or decision-making approach, appetite statements and measures should align with one of these categories.

We suggest organizations develop and communicate a common approach for grouping appetite into categories that align with strategy, objectives, or risks.

Strategic categories

Strategic categories may relate to growth initiatives, business efficiency, customer focus, or corporate responsibility. These are typically set out in a strategic plan or an annual report. Most often, there are fewer than 10 key categories at the highest level.

Categorizing by commonly used objectives

Some organizations will choose to articulate appetite using commonly used objectives. These categories may follow either a general scheme or one that is more expanded and tailored.

General schemes typically refer to the categories of operations, reporting, and compliance or obligations. These categories are commonly applied in internal control and some risk management approaches, and many in those roles are familiar with them. However, these categories do not always resonate outside of risk and control functions, especially those in an operations role.

EXAMPLE 5

Financial institution categories

A financial institution set out five key strategic categories of where the organization would succeed in pursuit of its mission and vision. These categories related to:

- Attaining sustainable, long-term growth.
- Providing strong customer service.
- Attracting, developing, and retaining the strongest talent.
- Innovating to enhance customer service and internal efficiency.
- Supporting the communities it serves.

By aligning appetite statements to these categories, the organization can anchor the guidance in language familiar across all levels of the organization.

Although the example shown is for a financial institution, this approach applies across industries. Some organizations will use internal business categories that exist at an operational level versus the strategic level in this example.

Tailored schemes allow for greater context of the business. Categories of objectives might include, for instance, aspects of operations such as human resources/talent, information technology, or production/product quality.

Categorizing by types of risk

Some organizations prefer to articulate appetite according to a common risk taxonomy that is based on common characteristics of risk. This approach lends itself to monitoring and emphasizes acceptable levels of risk given the unique consideration of each type of risk. However, this approach may result in an organization managing risk in silos. The best way to avoid that is to adopt an approach that integrates risk and performance—focusing on the desired performance and outcome, regardless of where the risk may originate in the entity.

USING RISK APPETITE TO ENHANCE PERFORMANCE

Appetite can be viewed through both a risk lens and a performance lens. A performance lens asks basic questions such as, “How much risk am I willing to take to achieve an objective?” If it is too much, then a different approach is needed. The performance lens can help management and the board identify whether the organization is not taking enough risk to achieve desired objectives.

Boards and management will need to strike a balance between risk and intended performance. For instance, consider two companies faced with a changing business environment and the need to innovate. Company A believes it can enhance its performance over its peers by being the first to successfully innovate. It may try new ideas often, fail quickly, and repeat this approach to attain the “first mover” advantage. It will require a higher appetite to be successful as it consumes greater resources to attain higher performance, but the potential large return is built into this approach.

Conversely, Company B may prefer to be a later adopter, setting a lower appetite for making decisions that consume resources while understanding that it will likely experience lower performance in the market. On the other hand, there is a risk that Company B wants high performance, but is not willing to take the risks needed to attain desired performance.

We suggest organizations develop a philosophy on risk-taking and performance; for example, whether you would accept higher risk for greater performance or whether you would be satisfied to accept lower performance to limit risk.

Perspectives on performance

Perspectives on attaining performance often vary within an organization. For senior management, appetite focuses on decisions that impact the strategies and objectives, and overall performance goals. Ideally, there is a healthy discussion and debate of how senior management and the board envision decisions. Appetite at this level is often highly aggregated and requires cascading levels of specificity in the organization. Measures may also be put in place for evaluating strategic priorities.

Once strategy and objectives are set, the focus shifts to execution. Here, other levels of management and those in day-to-day execution roles are also engaged. Boundaries are set for acceptable variation in performance using measures developed for monitoring performance. We depict this variation and monitoring as risk tolerance.

Business operations may also develop specific indicators to alert management when the level of acceptable risks is exceeded. When this happens, it should trigger discussion within the organization.

The following diagram illustrates how performance links appetite through tolerance, and indicators and triggers.

Figure 4. Appetite, tolerance, and indicators and triggers



Tolerance

Unlike appetite, which is often broad, tolerance is tactical and focused. Ideally, tolerance:

- Applies to significant objectives.
- Cascades throughout the entity providing guidance to those executing on a day-to-day basis.
- Supports the understanding of appetite.

In setting tolerance, the organization considers the relative importance of each objective. Highly significant objectives are often assigned low-risk tolerances. The key point here is that tolerance focuses on objectives and performance. Specific risks are considered as part of performance goals.

Resources become a specific consideration in the decision of where to set tolerance. The lower the range of tolerance, the more likely greater resources are required to stay within that range.

EXAMPLE 6 Setting tolerance

A company manufactures glass bottles. A number of production factors can influence the final bottle size, including raw material purity, temperature, and condition of the manufacturing equipment.

The company makes bottles of a specific size and will meet its contractual obligations if the bottles are within 2.5% of stated size (tolerance). The company is considering lowering this tolerance to +/-1.5% to attract a new customer. The decrease in tolerance will require more resources to attain tighter manufacturing precision, including quality control processes, machine maintenance, and perhaps machine upgrades. On the other hand, the success of getting a new customer may also pass on to other entities, and lead to higher overall performance and income over time.

Tolerances are specified up front and provide insight into decisions made. When actual performance is outside boundaries, management and the board should challenge the organization to bring performance back in line with plans, by either taking on more risk where tolerance is below the lower boundary or curtailing risk where tolerance is above the upper boundary. Yet, there may be instances where there are business reasons for operating outside of these boundaries.

Although appetite provides guidance for management to consider in decision-making, appetite alone cannot replace or supersede management judgment. Management may identify a significant business opportunity with significant upside potential that would take the risk above an upper boundary. Similarly, there may be times when management sees the need to curtail operations in anticipation of future events. Management may also revisit the established tolerance levels to determine if they remain suitable.

We suggest organizations develop a view on how risk appetite will cascade into the organization through the use of tolerance, indicators and triggers (e.g., at the board and senior management level, day-to-day-operations, compliance, and monitoring).



Building appetite into day-to-day practices

Management cannot just assume that responsible individuals will make decisions within the intended appetite. Therefore, organizations need to review the application of appetite through other practices. These may include the following:

- Expanding the time allocated to performance versus appetite in senior management meetings, considering both over- and underperformance.
- Integrating appetite statements into business cases, so that major decisions are made with a full consideration of risk (e.g., by adding questions that link to appetite statements).
- Conducting sessions on appetite with those with key decision-making authority, taking them through scenarios considered when developing appetite to reinforce the desired type and amount of risk to be taken on.
- Reviewing reports on actual or expected changes in the external environment, including megatrends shaping the overall future of the business.
- Enhancing reporting to management and board on how actual performance and risks are tracking versus expectations.
- Incorporating any appetite and tolerance measures into an existing governance, risk, and compliance system.
- Incorporating appetite within senior management's personal plans and objectives.
- Reflecting tolerance in operating policies and procedures.

EXAMPLE 7

Gaining acceptance within the organization

An organization was considering how to gain acceptance for using appetite in decision-making. The director of enterprise risk management ran a workshop, dividing attendees into two teams. Each team was presented with a scenario that required analysis and a decision to proceed with the plan. Each team discussed, then presented their decision and how they arrived at it. Team 1 was given a copy of a newly drafted set of appetite statements. Team 2 was not given this guidance.

When it came time to debrief, it was clear to all attendees that Team 1—those with the appetite statements—had a much more robust business conversation. Team 2 tended to default to their own area of experience in reaching a decision. Team 1 had used the appetite statements to consider a great number of perspectives before reaching a decision. The outcome did not just “anchor and adjust” from experience, but rather it provided a broader and richer analysis, leading to more comprehensive discussion.

We suggest organizations integrate risk appetite and tolerance into the review and revision practices used to evaluate performance.

Review and revise when needed

Once an organization's appetite is developed and communicated, management, with board support, must revisit and reinforce it. Appetite cannot be set once and then left alone for extended periods. A review is especially important whenever the organization's business context begins to change. These may include, for instance, the following:

- Viewing performance as depicted in established tolerance levels. Where actual performance is approaching the boundaries of acceptable levels, either develop plans to bring performance in line with established limits or revisit the established limits to determine if they remain appropriate given the current business context.

- Considering how often the organization approaches set boundaries. If an organization never approaches these boundaries, or constantly exceeds them, perhaps management doesn't have a clear strategy, doesn't understand, has a poorly constructed appetite, or is not behaving consistently with its own rules.
- Probing into appetite and decision-making when established tolerance levels are exceeded, either too high or too low; for instance, asking whether some form of misunderstanding of appetite existed when decisions were made or resulted in this level of performance.

EXAMPLE 8 A company's challenge

Management of a company asked the insightful question, "How often are we operating outside of the set tolerance?" In exploring this question, they noted that at any given time, as much as 5% of its performance measures were outside the established boundaries, and a further 10% were approaching those boundaries. Management understood that where performance never approaches the boundaries, it likely has less consideration in decisions. Yet, if performance is frequently outside of tolerance, do these boundaries curtail management judgment, or does it mean that they are making decisions without understanding the underlying risk? Management was faced with the challenge of determining whether this level of performance versus appetite indicated that appetite and tolerance formed a healthy level of feedback on decisions or whether established levels needed revisiting.

We suggest organizations draw on continual improvement practices. As part of internal reporting practices, report variation from desired risk appetite to management and the board.

These phases are interactive, with the board and management revisiting each one as needed. The board serves in an oversight role by checking in with management periodically and probing to see when appetite may need revising. Management revisits appetite periodically, adjusting as business and operational conditions warrant. At a minimum, management and the board should revisit these stages whenever strategy is changing.

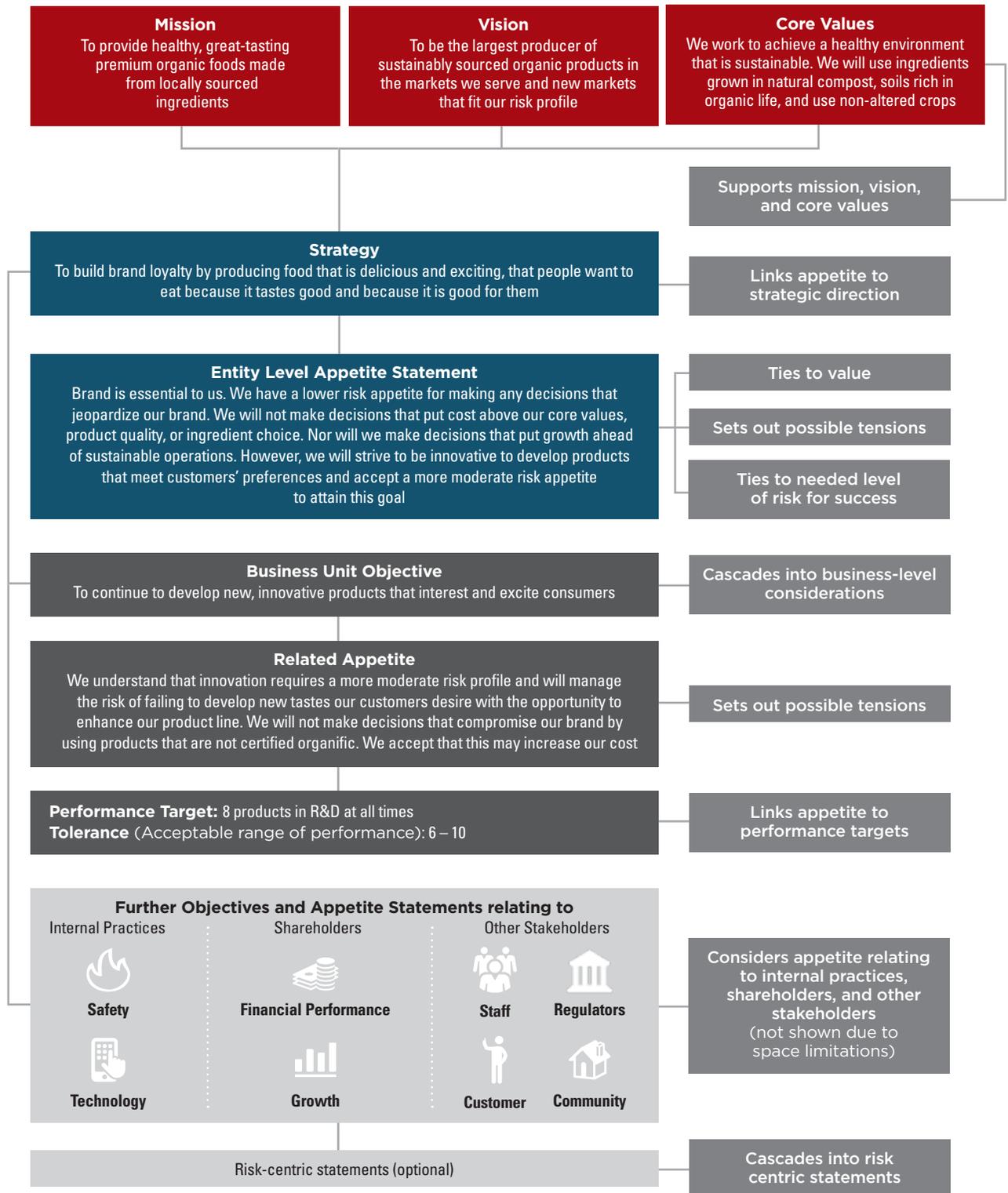
We suggest organization set a specific time period for revisiting these stages to ensure that risk appetite remains current.



Pulling it all together

The following chart illustrates how the points come together into a well-articulated view of appetite and tolerance.

Figure 5. Appetite and Tolerance



SUPPORTING THE USE OF APPETITE

Throughout this paper we have referred to “boards” and “senior management.” They both play a pivotal role in endorsing the importance of appetite, and creating the practices and culture needed to bring appetite to life within an organization.

We have stressed the board’s role in developing appetite and in considering whether appetite aligns with its expectations. We have noted the importance of management in developing appetite from the top and cascading it throughout the organization. Yet, the responsibility does not end there. As noted, appetite cannot be set once and then left alone. Someone at a senior level in the organization needs to take up the task of supporting its use. This includes helping those in front-line roles incorporate appetite into day-to-day practices and develop needed indicators. Management may wish to develop an easy-to-refer-to set of guiding principles for day-to-day management to use. Appendix B provides a summary of key tasks in a generic infographic that can be tailored by the organization.

Exactly who does this must be decided by the board and senior management. In some instances, the choice is clear (e.g., a chief risk officer, if there is one in the organization). In other instances, the board and senior management will need to identify an individual with the appropriate capabilities, capacity, and internal credibility to take on this role. What we have seen is that in the absence of having someone accountable, efforts to develop appetite are seldom sustained in practice.

We suggest organizations identify a responsible person to support the development and use of risk appetite.



FINAL THOUGHTS

Organizations take risk to succeed. But risk can't go unchecked. Setting and understanding risk appetite is an important element of corporate governance, strategic planning, and decision-making. Determining appetite through a performance lens requires deep discussions that affect management and boards and, to be effective, permeate an organization's culture. In this way, appetite reflects the mission and integrates with objectives with the end goal of adding value. Monitoring complements the decision-making lens of appetite and encourages all parts of the organization to be on the same wavelength.

Making informed decisions considering risk takes effort. We have seen first-hand how appetite helps improve the depth of consideration in decision-making. We believe the effort is worth it.



APPENDIX A. Appetite and Enterprise Risk Management—Integrating with Strategy and Performance

In 2017 COSO released *Enterprise Risk Management—Integrating with Strategy and Performance* (the “Framework”). The Framework renewed the conversation on appetite and clarified the relationship between appetite and tolerance. It emphasized the importance of the following:

- Linking to mission and vision as the first anchor of appetite.
- Applying appetite in the development of strategy.
- Making appetite about strategies and objectives, not risk.
- Using appetite in decision-making.

- Focusing on the level of risk requisite for performance.
- Viewing appetite through the lens of stakeholders.
- Linking higher-level guidance on decision-making with business-focused metrics.

The diagram below illustrates the five Framework components and their relationship with the entity’s mission, vision, and core values and the entity’s overall direction and performance. Within these 5 components are a series of 20 principles that represent the fundamental concepts associated with each component. Principle 7 specifically focuses on defining appetite and is captured within the blue ribbon in the illustration.

Figure 6. Risk Management Components



Source: COSO *Enterprise Risk Management—Integrating with Strategy and Performance*

Appetite is integrated throughout the enterprise risk management, as is captured in each of the five components. A few of those integrations relate to the following:

- Applying judgment as noted in Governance and Culture.
- Defining appetite and evaluating alternative strategies, and formulating objectives as noted in Strategy and Objective-Setting.

- Assessing the severity of risk and prioritizing responses as noted in Performance.
- Reviewing risk and performance and pursuing improvements in enterprise risk management as noted in Review and Revision.
- Communicating risk information as noted in Information, Communication, and Reporting.

Additional guidance is available in *Enterprise Risk Management Integrating with Strategy and Performance: Compendium of Examples*, specifically the examples on the energy company and the not-for-profit organization.

Forming an objective-focused view

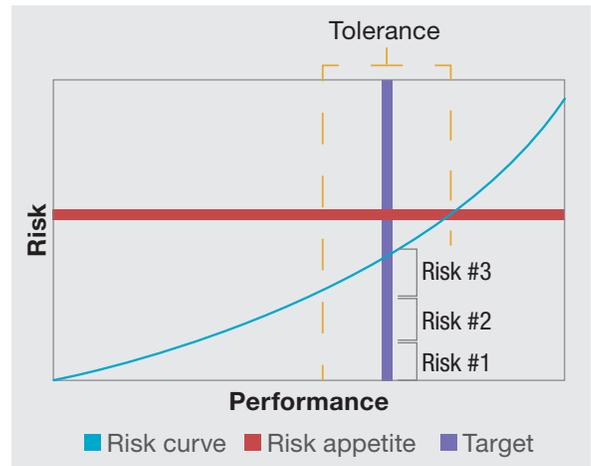
The Framework provides specific discussions on forming an objective view, recognizing that there can be positive or negative correlations between risks. This paper assists in understanding appetite relative to objectives, and the likelihood of achieving those objectives. An organization will need to understand the associated risks and interaction between those risks in developing its risk profile.

The figure on the right was developed from the *Framework*⁴ and depicts the following:

- An amount of risk considered acceptable (red line ).
- The risk curve, which, in this instance, increases as performance levels increase (blue line .
- A target set within appetite (purple line .
- Tolerance as boundaries of acceptable performance (dashed yellow line .
- Individual risks that aggregate in forming the current amount of risk to achieving the objective.

This diagram highlights several important points, as follows:

- 1 Tolerance and appetite relate to different aspects of enterprise risk management. Tolerance is relative to performance targets, not risk.
- 2 Risks #1 through #3 illustrate the profile view. Appetite needs to consider a broad view of risk, encompassing all risks that impact performance.
- 3 Only in very rare situations would an organization choose to set a performance target, including acceptable levels of variation (tolerance), above the appetite—that's why the right side of tolerance intersects appetite. Operating within acceptable levels of variation keeps an organization within tolerance.



⁴ This graphic combines Figure 7.5 and Figure D.7.

APPENDIX B. Summary of Key Tasks

Figure 6. We Suggest Organizations:

Linking Appetite and Strategy	Adopt an objective-focused approach, which cascades into risk considerations, unless there are specific regulatory or other business reasons limiting this choice.	
Inputs to Appetite	Determine whether the organization will apply a monitoring approach or one that integrates decision-making and monitoring practices.	Analyze stakeholders' views that may affect the organization's view of risk appetite.
	Determine whether to include both lower and upper boundaries.	Consider the organization's unique business context when setting risk appetite.
	Consider the extent to which natural tension will be designed into risk appetite.	Capture key inputs and consider how to incorporate them into risk appetite (e.g., mission and vision, current strategic direction, risk profile, and culture).
Developing Appetite to Support Strategy and Objectives	Develop an approach that includes facilitated discussions related to mission and vision, discussions related to strategies and objectives, analysis of performance, or other approaches preferred by the organization.	Include in the development of appetite both senior levels of management and those engaged in day-to-day activities.
	Keep the organization's strategic plan, including mission and vision, at the forefront of facilitated discussions on appetite. Avoid biasing discussions toward only one or two lines of the business.	Debate and discuss with management and the board the levels of risk that seem too high or low.
	Adopt language that resonates with both the stakeholder group and at varying levels within the organization.	Develop a plan to validate risk appetite, using the approaches developed within your organization.
Articulating Appetite to Support Decision-making	Review the current level of precision in their appetite statement and ask if it has evolved as overall risk management capabilities have matured.	Use language that mimics that used for strategy and objectives.
	Develop a philosophy on risk-taking and performance; for example, whether you would accept higher risk for greater performance or whether you would be satisfied to accept lower performance to limit risk.	Develop and communicate a common approach for grouping appetite into categories that align with strategy, objectives, or risks.
Using Appetite to Enhance Performance	Develop a view on how risk appetite will cascade into the organization through the use of tolerance, indicators and triggers (e.g., at the board and senior management level, day-to-day-operations, compliance, and monitoring).	Integrate risk appetite and tolerance into the review and revision practices used to evaluate performance.
		Draw on continual improvement practices. As part of internal reporting practices, report variation from desired risk appetite to management and the board.
		Set a specific time period for revisiting these stages to ensure that risk appetite remains current.
Supporting the Use of Appetite	Identify a responsible person to support the development and use of risk appetite.	

ABOUT THE AUTHORS



Frank Martens is the owner of Pacific Rim Risk Management Services. He has worked with all levels of management—from managers through to C-suite executives and board members—and with companies of all types and sizes. For over 30 years he was a Director at PricewaterhouseCoopers. Mr. Martens was the Global Risk Framework and Methodology Leader. In that role, he provided thought leadership on enterprise risk management and support to client teams across multiple countries and a wide range of industries.

Mr. Martens has authored or co-authored over a dozen significant publications on enterprise risk management and internal control and was the lead project director on *Enterprise Risk Management—Integrating with Strategy and Performance* and the prior *Enterprise Risk Management—Integrated Framework*. He has presented on the topic of risk management in Asia, Australia, Europe, North America, and Central America. He has hosted podcasts and written blog posts on risk management and its relationship to strategy, performance, disruption, and emerging technology. He has conducted quality assurance reviews on risk management training curricula. Moreover, he has helped develop senior professionals' thinking and approaches to help enhance the benefits attained from enterprise risk management. He is a Chartered Professional Accountant and has attained the COSO ERM Certificate of Educational achievement.



Dr. Larry Rittenberg is the Ernst & Young Emeritus Professor of Accounting at the University of Wisconsin–Madison School of Business. He is one of only eight academics on the list of the United States' 100 most influential people in finance. Dr. Rittenberg was on the COSO steering committee that oversaw the development of *Enterprise Risk Management—Integrated Framework* and later served as chair of COSO. As chair, he led the effort to provide guidance for small and midsize companies on developing effective internal controls, and later he led COSO in developing guidance on monitoring of internal controls.

On the University of Wisconsin faculty since 1976, Dr. Rittenberg has taught audit and assurance, risk management, and corporate governance. His research deals with the effectiveness of audit committees, corporate governance, and assurance services. He has received the Bradford Cadmus Memorial Award, The Institute of Internal Auditors' highest award, for his contributions to the internal auditing profession, and he was one of 16 inducted into the IIA Distinguished Practitioners.

Note to Readers

The information contained herein is of a general nature and based on authorities that are subject to change. Applicability of the information to specific situations should be determined through consultation with your professional adviser. This thought paper represents the views of the authors only and does not necessarily represent the views or professional advice of the University of Wisconsin, Pacific Rim Risk Management Services, or COSO.

ABOUT COSO

Originally formed in 1985, COSO is a joint initiative of five private sector organizations and is dedicated to providing thought leadership through the development of frameworks and guidance on enterprise risk management (ERM), internal control, and fraud deterrence. COSO's supporting organizations are the American Accounting Association (AAA), the American Institute of Certified Public Accountants (AICPA), Financial Executives International (FEI), the Institute of Management Accountants (IMA), and The Institute of Internal Auditors (IIA).

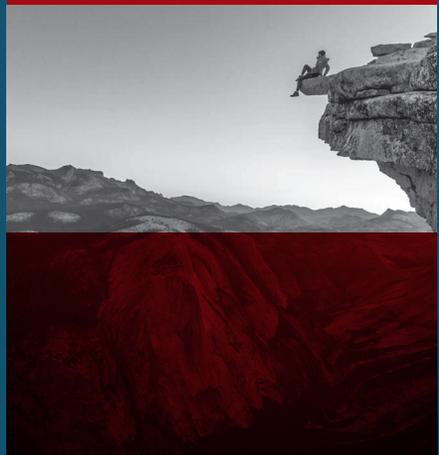


.....

This publication contains general information only and none of COSO, any of its constituent organizations or any of the authors of this publication is, by means of this publication, rendering accounting, business, financial, investment, legal, tax or other professional advice or services. Information contained herein is not a substitute for such professional advice or services, nor should it be used as a basis for any decision or action that may affect your business. Views, opinions or interpretations expressed herein may differ from those of relevant regulators, self-regulatory organizations or other authorities and may reflect laws, regulations or practices that are subject to change over time.

Evaluation of the information contained herein is the sole responsibility of the user. Before making any decision or taking any action that may affect your business with respect to the matters described herein, you should consult with relevant qualified professional advisors. COSO, its constituent organizations and the authors expressly disclaim any liability for any error, omission or inaccuracy contained herein or any loss sustained by any person who relies on this publication.

Thought Leadership in ERM



COSO

Committee of Sponsoring Organizations
of the Treadway Commission

coso.org

Thought Leadership in ERM



**RISK APPETITE-
CRITICAL TO
SUCCESS**

**USING RISK APPETITE TO THRIVE
IN A CHANGING WORLD**

COSO

Committee of Sponsoring Organizations of the Treadway Commission

coso.org