

# ENTERPRISE RISK APPETITE

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## INTRODUCTION

Setting and embedding the enterprise risk appetite is a critical function of the board. Some level of risk is inherent within all organisational activities: there are strategic and competitive risks around return on investment; internal and operational risks such as health and safety, cybersecurity, culture, ethics and reputational risk; as well as external risks such as megatrends in the environment, the economy, society and politics.

An appropriate enterprise risk appetite is one that is aligned with the organisation's purpose and strategy to meet the expectations of its owners/ promoters, shareholders or key stakeholders. A business that is scaling up may employ a high-growth, high-capital expense strategy, while a more established organisation may pursue more stable and moderate growth. All boards should consider the strategic risks posed with respect to their organisation and have plans in place for both short-term crisis management and long-term mitigation.

The board plays an ongoing progressive role in the successful implementation of a risk management framework by monitoring the enterprise risk appetite, defined risk tolerance levels and the adherence with the risk mitigation plan. Risk reporting is an important component for board oversight; however, it must go further than 'tick in the box' compliance. Education and culture are key to ensuring that the employees in the organisation understand and are equipped to operate within acceptable risk tolerance.

## SIX THINGS TO REMEMBER ABOUT ENTERPRISE RISK APPETITE

- i. Risk appetite is not a separate framework
- ii. Risk appetite and risk tolerance differ
- iii. Risk appetite applies to more than the financial services industry
- iv. Risk appetite is at the heart of decision making
- v. Risk appetite is much more than a metric
- vi. Risk appetite helps increase transparency

## 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 *COSO Framework*, appetite flows through all aspects of enterprise risk management. 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 status quo constitutes a risk that management must also assess.
- ▶ Risk appetite need not be about quantification.

## LINKING ENTERPRISE 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 enterprise 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.

## THE SURVEY

As part of a joint initiative with BDO, the Australian Institute of Company Directors (AICD) conducted a survey of a range of senior organizational leaders, including directors and executives, on their organizations' risk appetite. Participants came from all sectors, including listed companies, not-for-profit, private businesses and government organisations.

The results showed a consistent acknowledgement of the importance of risk management. At the same time, it revealed significant gaps for many organizations in their risk management compared to what may be considered 'good practice'. The gap between principle and practice can leave risks unmitigated, or on the other hand mean that an organization is fearful of taking risk because of lack of clarity around what is acceptable. This can have a significant negative impact on organisational performance.

## CULTURE AND UNDERSTANDING

This survey shows that **culture and understanding** are the two key challenges of coming to grips with enterprise risk appetite. However, organisations get a much better handle on their risk when a top-down approach is taken in which all the layers of an organisation are included. For boards, this means it is essential to take the time to understand their organisation's culture in creating successful risk appetite approaches.

Improving reporting to the board to give it a better grasp of the disruptive forces and the risks the business is willing to take to meet that disruption will also be important.

Ultimately, enterprise risk appetite is an essential part of dealing with disruption, and directors need to ensure their organisations are able to understand the risks they are willing to take relative to return on investment as soon as possible. Only then will their businesses be able to survive and thrive in the long term.

## OVERALL KEY FINDINGS

Few organizations have formalized their enterprise risk appetite approach.

- ▶ Only 6.2% of organizations identified as having formalized risk appetite statements that were documented in policies and procedures, supported by limits and thresholds that established parameters for specific risks.
- ▶ Public companies and not-for-profits identified as having higher maturity than their counterparts, with the risk appetite maturity for these organizations strengthening with age of implementation.
- ▶ Organizations in the manufacturing; education and training; and agriculture, forestry and fishing industries were identified as holding the highest level of maturity.

## SUMMARY

As organizational risk appetite matures, the advantages and importance of being able to have strategic risk conversations is still perceived as the greatest advantage, although the incremental benefit experienced year on year decreases over time. Attention and benefits then turn to an increase in fostering organizational culture and supporting the overall risk appetite journey.

The benefits derived from fostering culture throughout the organization also paves the way for other advantages to be experienced such as improvements in the effectiveness of risk/return decision making and reporting against risk profile/benchmarks and enterprise risk appetite.

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