

# The importance of defining risk appetite



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**COUNTING BEANS**

**Under Singapore's Code of Corporate Governance, the Board should determine the company's level of risk tolerance, specifically the nature and extent of the significant risks it is willing to take to achieve strategic objectives (Principle 11). In practice, this task is often delegated to either the Audit Committee or the Board Risk Committee.**

With the increased importance of operational risks today, the scope of this task has grown substantially. So has the audit committee's workload. A recent KPMG global survey of audit committees found that over half of audit committees in Singapore now spend significantly more time fulfilling their responsibilities.

Risk oversight is critical to any company. Good risk oversight reduces the odds that a company will experience going-concern issues. However, risk oversight now constitutes a very large proportion of the audit committee's workload.

To some extent, this increased workload may be attributed to an insufficient understanding of the board's risk appetite. For example, if a board has not adequately defined the amount of risk it is willing to accept, the audit committee may end up simply adding every new issue to its agenda - even those that do not warrant the board's attention.

To better balance the workload, boards should attempt to gain a better understanding of their risk appetite.

## Difficulties with Understanding Risk Appetite

Several issues may impede the board's understanding of risk appetite.

The first is the "check-box" approach that many boards take to defining their risk appetite or risk tolerance. However, the "check-box" approach may not be the most effective as it may be too generic in nature. It may even add to the burden of the audit committee by being too conservative resulting in a larger volume of risks/decisions being escalated or by being poorly defined leading to inconsistencies in the company's risk management policies. Boards need to consider whether their definition is appropriate to the company's situation.

In other cases, the board may not have a sufficiently good understanding of the company's strategy and risks. Hence, they are unable to determine the specific levels of risks that are acceptable for the company's current position.

Another possible obstacle is that the audit committee may not have received sufficient or quality information about key risk areas. For example, the KPMG survey discovered that 40 per cent of audit committees in Singapore felt they did not receive quality information on critical risk areas such as supply chain risk, cyber security, and systemic risk. Such lack of information may prompt the audit committee to take a conservative position regarding risk appetite.

### Attaining a Clearer Definition

The most basic method of defining risk appetite is to consider the company's current stage of growth. The faster the company wishes to grow, the higher its risk appetite should be. Then when the company reaches or wishes to maintain a stable state, the board should moderate its risk appetite.

The company's industry will also significantly affect its risk appetite and tolerance. In the fast-moving high technology industries, for example, companies may have a much higher tolerance for risk. But in regulated industries such as the financial industry where compliance is of great importance, the risk appetite should be very low.

To minimise the possibility of "mission creep" – the addition of more items to the audit committee's agenda regardless of relevance or necessity – boards and audit committees need to ensure that they have a solid understanding of the business strategy and risks.

To better balance the workload, boards may also wish to reallocate their risk oversight responsibilities. This may involve creating new

committees to focus on specific categories of risks such as Health and Safety. Several boards in Singapore are already moving in this direction.

Boards may also consider bringing in additional expertise, depending on the company's direction. For example, if a company is in a phase of inorganic growth, the audit committee might wish to include M&A expertise.

At the same time, boards and audit committees need to communicate more closely with management, especially key functional personnel such as financial controllers or information officers. This would help to improve the information they receive about key risk areas, and contribute to their understanding of the business.

### A Tool to Enhance Performance

In today's operating environment, it often appears difficult to attain both effective risk management and a balanced workload for the audit committee. Risk appetite can act as a tool to achieve and enhance the company's performance.

A well-defined risk appetite acts as a tool to regulate the audit committee's workload by streamlining its agenda. The potential benefits of this include more time for quality discussions, a deeper understanding of the business, and better understanding of the board's risk oversight responsibilities.

Risk appetite also acts as a guideline for the board to set clearly defined limits on what the company can do and what it should avoid. This may extend to various aspects of the company's operations, including investment strategy, growth plans and even talent recruitment.

At the end of the day, risk appetite regulates many other large and small decisions that have significant impact on a company's performance. The better articulated the board's risk appetite is, the more useful it will be. ■

