Risk Tolerance- What is reasonable?

Highlights

- Define agency risk tolerance.
- Ensure the risk tolerance definition is both specific and measurable.
- Balance internal controls with the need to achieve agency mission.

Think about activities you perform where you accept risk to achieve an important goal. When you drive to work you accept the risk of an accident. When you exercise to improve your health, you accept the risk of an injury. Dealing with risk requires balance. It is reasonable to accept some risk to achieve important goals and objectives in your life. The same standard of “reasonableness” applies to running an agency and implementing internal controls. But what is reasonable and how much risk is too much?

The amount of risk an agency is willing to accept is its “risk tolerance.” Risk tolerance is the acceptable level of discrepancy in performance relative to the achievement of objectives. In other words, how much risk can management accept and still work effectively. The key is to find balance – this is where “reasonableness” lives.

How much risk to accept and what provides reasonable assurances begins by management defining risk tolerance. Risk tolerance should be specific and measurable. This helps management to identify when risk exceeds an identified threshold and to respond accordingly.

Consider the agency mission. The definition of a reasonable risk tolerance level begins here. If internal controls block agency objectives, adjustments could be needed. The goal here is to remain consistent with requirements and expectations for the defined objectives.

Second, agencies should establish risk tolerance that aligns with its goals for quality and quantity. Determine whether risk tolerance aligns with the agency goals for quality. Accepting a high risk tolerance in areas that require attention to detail can be detrimental. When considering risk tolerance and quantity, too low of a risk tolerance may result in excessive controls.

Review the applicable laws, regulations, and standards. Consider the agency’s standards of conduct, oversight structure, and expectations of competence. The concept of risk tolerance does not apply to compliance. An agency is either compliant or not compliant.

Once management defines risk tolerance, reasonableness is achieved through cost benefit analysis, weighing the probability of risks and resulting consequences. The cost of some controls can outweigh the benefits. No one has unlimited resources to reduce risk. You need to balance controls against the likelihood and impact a risk poses.

Suggested Action Steps:

Make sure you know how your agency defines risk tolerance. Create a shared understanding of risk tolerance and what it means in day to day processes. Once the agency understands risk tolerance, work towards refining its practical application. Align risk tolerance with agency goals for quality and quantity. Analyze risk tolerance for reasonableness through cost benefit analysis, probability of risks occurring, and the consequences.

If you have questions, please contact at Jacob Rossow or 651-259-3828.