Managing Reputational Risks

Using risk management for business ethics and reputational capital.

By Greg Young and David S. Hasler

Lapses in business ethics can lead to enterprise costs, damaged relationships with key stakeholders, and lost opportunities that significantly harm financial performance. Conversely, an enterprise's reputation for ethical conduct can be a crucial asset for achieving its strategic and financial objectives. It's surprising, therefore, that the role of ethics and reputational capital are the least developed aspects of enterprise risk management (ERM).

The *Enterprise Risk Management—Integrated Framework* and guidelines from the Committee of Sponsoring Organizations of the Treadway Commission (COSO) are fast becoming standards for best practices in organizations (www.coso.org/guidance.htm). While there are many varieties of ERM in practice today, all recognize that ethical values underlie a firm's ability to accomplish enterprise objectives. Yet much of the current discussion about ethics focuses on corporate culture, conduct, and compliance in a post-Enron world of the Sarbanes-Oxley Act (SOX) and corporate sentencing guidelines. Though important, these dimensions don't directly examine the value of ethics as an asset to build trust in important business relationships. As a consequence, most people's understanding of best practices to manage business ethics is limited.

Here we explore stakeholders' perceptions of ethics in order to bring reputational capital more clearly to the forefront of ERM. We do so by extending the ERM paradigm to identify and assess risks to reputational capital. First, we suggest a process to identify the scope of ethical principles and behaviors that are most appropriate for building reputational capital by illustrating this process with the *IMA Statement of Ethical Professional Practice*. Second, we account for differences in enterprise context that systematically narrow the focus of ethics governance. Third, we describe a framework that integrates ethics with the COSO ERM components to elicit stakeholders' assessments of enterprise reputational capital.

What's at Stake?

The foundational role of ethics in ERM isn't surprising. Business misconduct can lead to direct costs of legal fees, monetary fines, sanctions, and operational recovery. Given a choice in partnering, stakeholders—relationship partners such as employees, customers, suppliers, community groups, and owners—are likely to prefer a relationship with an enterprise that has a reputation for integrity. For the enterprise, a reputation for poor ethics can lead to costs of replacing lost partners or going it alone. Labor, operating, and overhead costs may increase if the enterprise is perceived to be so unprincipled in its conduct toward employees that its recruiting and retention of skilled personnel are at risk. Similarly, purchasing, logistics, and overhead costs may increase if suppliers judge the enterprise to be unfair or dishonest.

In our post-Enron/WorldCom/Tyco era, reputations of large, publicly traded companies (for better or worse) are likely to be broadly known. Public reaction to notorious lapses in business ethics has increased worldwide legislative, regulatory, judicial, and media demands for visibility into corporate governance of business ethics. In this context, an enterprise reputation that fosters goodwill has economic value. Unethical conduct puts reputational capital—and economic value—at risk.

Traditionally, the practice of ethics management has focused on corporate ethical values within the organization and sequential activities to prevent, detect, report, and respond to misconduct. But this focus on misconduct limits people's understanding of ethics as a form of reputational capital that has value in important business relationships. Moreover, the focus on misconduct makes it difficult to integrate traditional ethics programs within the ERM framework.

Given such a consequential role for ethics and the momentum of ERM in current business practice, it's surprising that ethics isn't more developed in the ERM discussion. As George L. Head wrote in expert commentary for the International Risk Management Institute in February 2005 (see www.irmi.com/expert/articles/2005/head02.aspx), "[T]he fields of ethics and risk management need each other. Good risk management and good ethics are, and need to be, linked...[but] I have used the word 'ethics' in print probably less than 100 times."

Two important obstacles to extending ERM to ethics have been the difficulties in anticipating reputational risks and in quantifying reputational capital. We seek to overcome these difficulties with a structured process to elicit stakeholder judgments about a company's commitment to principled ethical behavior in their relationship.

Building on ethical responsibilities to stakeholders is increasingly recognized as a best practice in organizational ethics programs, but so far this approach hasn't been integrated with risk management. Importantly, quantifying stakeholder assessments lends itself to aggregation for an overall perspective on enterprise-level risk to reputational capital. Let's now look at a process that identifies the scope of ethical principles and behaviors most appropriate for building reputational capital.

Identifying Ethics and Behaviors for Reputational Capital

To illustrate a structured approach, we'll draw on principles from the *IMA Statement of Ethical Professional Practice*, which you can find at www.imanet.org/PDFs/Statement%20of%20Ethics_web.pdf, mapping them to the ethical content on which trustworthy reputations are built and describing enterprise behavior that embodies

Table 1: Ethical Principles and Enterprise Behavior:
Drivers of Reputational Capital in Enterprise-Stakeholder Relationships

IMA Principle of Ethical Professional Practice	Ethical Principles from Western Philosophy	Stakeholders' Perception of Enterprise Behavior in Relationship
Honesty	**Personal Virtue:** Act with the intention of causing pride and avoiding shame; take responsibility to nurture trustworthy relationships with honesty and integrity.	(a) Trustworthy, honest, cooperative, and deserving esteem. (b) Every level of the enterprise (i.e., each component of COSO ERM framework) nurtures relationship with stakeholder.
Responsibility	**Legal Compliance:** A responsible member of society does not violate laws enacted by legitimate legislative, regulatory, or judicial processes and nurtures relationships when legal institutions are just emerging or transitioning from one form to another.	Obeys established legal institutions governing the enterprise's operations; develops relationships to govern operations where legal institutions are not well-established.
Objectivity	**Economic Efficiency:** Act with the intention of achieving best possible profits without harming others, subject to market and legal constraints. Inform business relationships with objective information regarding product features, prices, and activity costs.	(a) Access to useful, unbiased information on product features, prices, and activity costs; (b) Does no harm to free markets, public safety, and environment while pursuing its own profit; (c) Alert to best profit-making opportunities.
Fairness (in outcomes)	**Distributive Justice:** Share value-added with stakeholders; form and sustain business relationships by showing fairness in care and respect for the needs of others; take responsibility to produce outcomes stakeholders prefer and find beneficial.	Fair in prices, costs, and activities to support stakeholders' preferences.
Fairness (in process)	**Procedural Justice:** Give stakeholders fair access to have their voice heard in your decision making so their interests are protected even if they disagree with a decision outcome.	Gives fair access to participate in activities and decisions.

that content in stakeholder relationships: "*The fundamental principles in the* IMA Statement of Ethical Professional Practice *are Honesty, Fairness, Objectivity, and Responsibility. Members shall act in accordance with these principles and shall encourage others within their organizations to adhere to them.*"

In Table 1 we juxtapose these fundamental IMA principles—honesty, fairness, objectivity, and responsibility—with concise descriptions of their associated ethical principles from Western philosophy—personal virtue, legal compliance, economic efficiency, distributive justice, and procedural justice. The table shows the explicit one-to-one relationship between the first three IMA principles and the principles of personal virtue, legal compliance, and economic efficiency. Interestingly, there are two philosophical flavors of fairness to discuss with stakeholders—fairness in enterprise outcomes and fairness in enterprise decision procedures (see Table 1, bottom two rows).

The value of reputational capital is a function of benefits gained and costs avoided because of stakeholders' willingness to cooperate in order to accomplish enterprise goals. As reputational capital increases, the enterprise can better leverage stakeholder relationships to increase its own productivity. As Figure 1 shows, the enterprise has ethical principles at its core that drive its behavior in relationships, stakeholder perceptions of the enterprise can be elicited in the structure of the ERM framework, and the enterprise-stakeholder relationship is the locus where a company earns reputational capital and the stakeholder grants it. The relationship is where stakeholders interact with the enterprise and detect the integrity with which enterprise behavior fits with its stated values. Reputation is the stakeholders' perception of patterns in these interactions and behaviors.

We describe a method to prompt stakeholders to identify and quantify their perspective on an enterprise's reputational capital. This method integrates the ethical principles described in Table 1 with the eight ERM components of the COSO framework. This structure elicits a comprehensive dialogue with stakeholders about the drivers of and risks to reputational capital in the enterprise-stakeholder relationship. The comprehensiveness of this approach is a particularly valuable aid to risk management when ethical principles aren't uniformly prominent within the enterprise.

Before we detail the integrated structure, we first describe the strategic context that influences management to be more attentive to some ethical principles and stakeholders and less attentive to others. In these situations, the comprehensive structure provided by integrating the ethical principles with the COSO framework guides risk managers to elicit stakeholder descriptions of enterprise reputational risk that might otherwise be overlooked.

The relative prominence of the ethical principles in the internal environment may vary from one enterprise to another. The unique context of an organization is likely to influence management to give more attention to some principles over others. Understanding the distinctive content of different ethical principles, therefore, gives insight into the basis for an enterprise's reputation with stakeholders. For example, the principles most prominent to the managers of a small corporation selling to a more powerful customer, such as a vendor selling to Walmart, may differ from those values most prominent to the managers of a large retailer sourcing from weaker suppliers, such as The Body Shop's relationships with small villages and women-led cooperatives in emerging economies.

Two important dimensions in an enterprise's strategic context—its ownership structure and its bargaining

Figure 1: Enterprise-Stakeholder Relationship Is Where Reputational Capital Is Earned

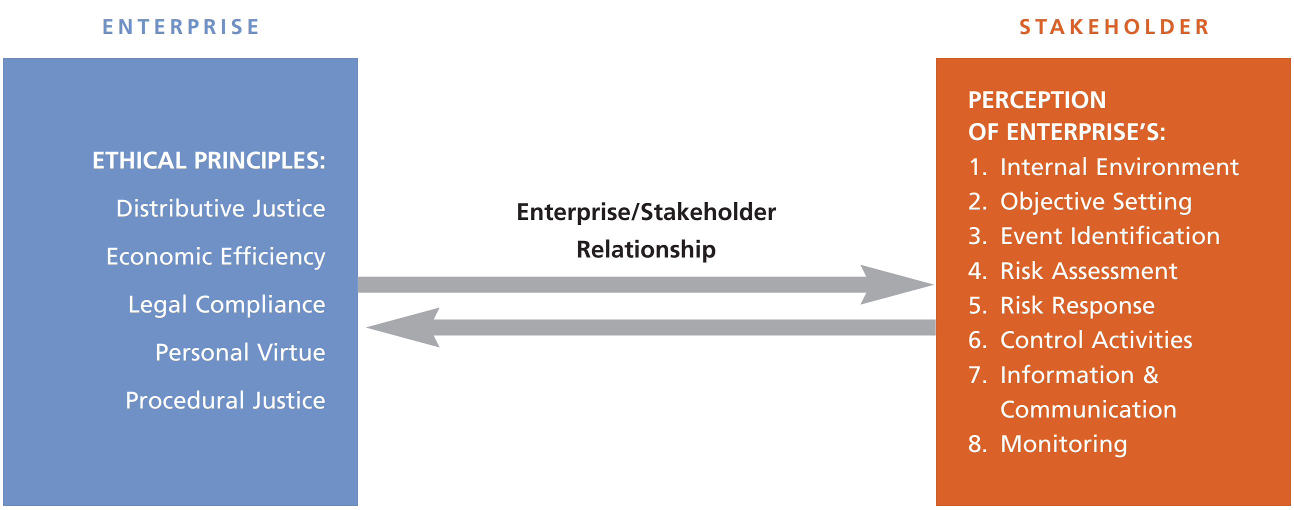
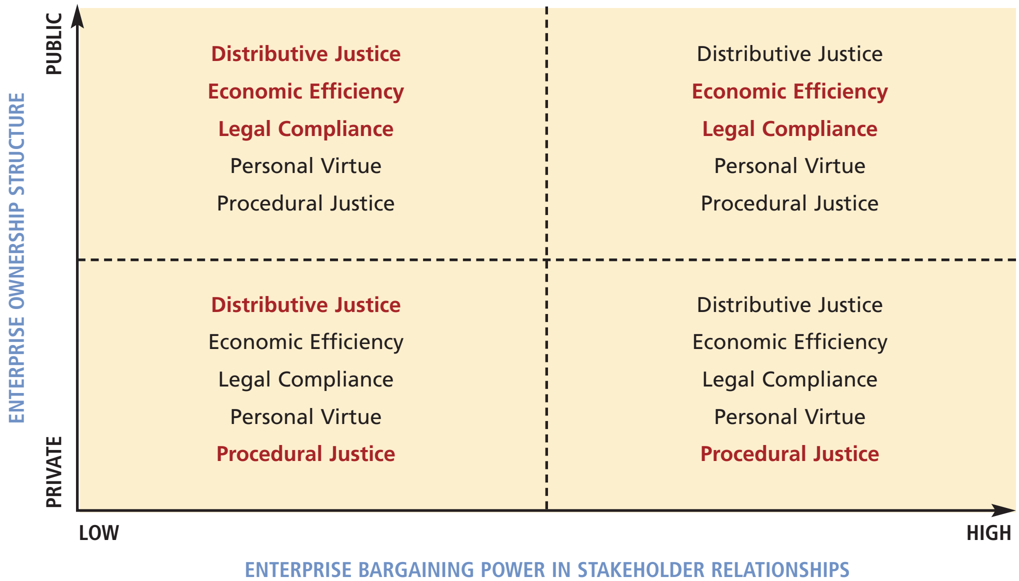


Figure 2: Enterprise Context and Expected Prominence of Ethical Principles in Enterprise Internal Environment

Words in color in boxes indicate ethical principles likely to receive more prominence in the enterpsie context.



power in stakeholder relationships—may cause its managers to view some ethical principles as more prominent than others in daily operations and decision making.

Publicly owned companies in the U.S. are subject to significant legal and fiduciary obligations and securities regulations, such as SOX. In this context, the legal compliance and economic efficiency principles are heavily weighted in the relationships of publicly owned enterprises with government and shareholders. It follows that ethics management in publicly owned corporations will prominently feature these two principles.

Privately owned enterprises, on the other hand, are relatively free of compliance requirements from SOX, the Securities & Exchange Commission (SEC), and shareholder lawsuits. Coming to the fore of management's attention instead are partners, customers, and suppliers, whose interests need to be represented fairly in organizational decision making. Accordingly, we expect justice principles will be prominent in stakeholder relationships with privately owned enterprises. When transactions, relationships, and contracts become increasingly complex but not tightly regulated by law, it becomes more difficult to anticipate all possible situations and contingencies that may arise. In this situation, stakeholders are likely to value opportunities to voice their preferences in the enterprise procedures and decision making—the definition of procedural justice.

In another context, an enterprise whose bargaining power isn't strong enough to compel agreements with its stakeholders may induce them to cooperate by calling attention to its reputation for fair distribution of added value. An enterprise culture with visibly prominent distributive justice principles is likely to attract and sustain critical relationships even when the enterprise lacks compelling power.

For example, a privately held Internet grocer in the New York area adds value for customers by offering quality "farm-fresh" food with the convenience of online shopping and home delivery. New customers were its biggest source of revenue, and, to attract them, the company offered discounts on large orders. Revenues were rising, but profits were falling as customers dropped the service after using their discounts. In addition, the business wasn't dominant in its local area, so customers had other grocery choices. In this context, we expect this online grocer would improve relationships with its customers by emphasizing its reputation for fair distribution of added value (see the lower-left cell in Figure 2). Earlier, we described fairness in outcomes as a form of the distributive-justice ethical principle and expressed the stakeholders' perspective as *"Fair in prices, costs, and activities to support stakeholders' preferences"* (see Table 1). In the case of the online grocer, customer behavior indicated that pricing for new customers was perceived as fair, but the quality of grocer activities supporting convenience and food quality wasn't supporting the preferences of existing

Table 2: Risk Management of Reputational Capital

	ERM Framework to Elicit Stakeholder Description of Enterprise			
	#1 INTERNAL ENVIRONMENT	#2 OBJECTIVE SETTING	#3 EVENT IDENTIFICATION	
PERSONAL VIRTUE (a) Trustworthy, honest, cooperative, and deserving esteem. (b) Every enterprise level in COSO ERM framework nurtures relationship with stakeholder.			(A) Stakeholder describes future events that, if they were to occur, would change the scores in cells of other columns. (B) For each event described in (A), stakeholder estimates the likelihood that it will occur in the forthcoming period.	
LEGAL COMPLIANCE Obeys established legal institutions governing the enterprise's operations; develops relationships to govern operations where legal institutions are not well-established.				
ECONOMIC EFFICIENCY (a) Access to useful, unbiased information on product features, prices, and activity costs; (b) Does no harm to free markets, public safety, and environment while pursuing its own profit; (c) Alert to best profit-making opportunities.				
DISTRIBUTIVE JUSTICE Fair in prices, costs, and activities to support stakeholders' preferences.				
PROCEDURAL JUSTICE Fair access to participate in activities and decisions.				

Table Key

Business ethics programs typically focus on **Personal Virtue** but need to manage reputational capital in ERM framework.

High power and public enterprises likely focus on **Legal Compliance** and **Economic Efficiency** principles of business ethics but may need to manage risks to broader reputational capital.

Reputational Capital and Risk

	#4 RISK ASSESSMENT	#5 RISK RESPONSE	#6 CONTROL ACTIVITIES	#7 INFORMATION & COMMUNICATION	#8 MONITORING
	Assume each event described in Column #3 occurs. (A) What is the new score in each cell of the other columns? (B) Stakeholder estimates the event's consequences (e.g., costs and benefits) for the enterprise.	For each event described in Column #3(A), consider these alternative enterprise responses: avoid the risk, accept it, reduce it, or share it with another party, such as with insurance or with accommodation from your stakeholder group. Make a judgment about each possible alternative response: Is it likely to make scores and consequences prompted in Column #4 better or worse?			

Business ethics programs need to do more to assess reputational capital as guided in ERM Components #3-5.

Low power and private enterprises likely focus on **Distributive Justice** and **Procedural Justice** principles of business ethics but may need to manage risks to broader reputational capital.

customers. To solve this problem, management shifted emphasis by substantially increasing investment in customer service and stopping promotional discounts for new customers. After two years of this approach, the bulk of revenue comes from repeat customers, and the company had its first profitable year (see the August 11 and August 17, 2010, issues of *The New York Times* to read articles about FreshDirect).

Figure 2 summarizes the important dimensions of the context we discussed. As you move along either axis, the types of stakeholders change, and their points of ethical emphasis evolve depending on your organization's influence and degree of public ownership. The figure shows that when enterprise power is low in comparison to that of its stakeholders (see the left column of Figure 2), then we expect that the enterprise is more likely to sustain important stakeholder relationships if it's willing to distribute the bulk of the added benefits to its powerful stakeholders, such as by passing along lower costs to customers by lowering prices.

Take, for example, small biotechnology firms that often partner with other businesses for complementary strengths that reduce the time to bring new drugs to market. Those small firms less willing to give up a larger portion of the added value are less likely to partner with large, powerful multinationals. Instead, they seek more accommodating partners, such as those from emerging economies, to form relationships in which the relative power is more comparable and the fairness of outcomes more closely defined by a distributive justice principle. One interesting example of this is the new drug discovery partnerships between small Western companies and Indian companies (see the November 25, 2006, issue of *India Business Insight*). Conversely, the opportunity to choose from among many small but equally acceptable potential partners in an honest and free market gives large multinationals the ability to negotiate and enforce more self-interested outcomes.

For publicly owned companies with relatively high power in stakeholder relationships, Figure 2 shows that we expect a reputation for economic efficiency and legal compliance to be the larger contributors toward forming and sustaining important relationships critical to achieving enterprise objectives.

For example, many leading mortgage lenders recently announced plans to exit the subprime segment of the residential mortgage market because of increased regulatory constraints and reduced prospects for profitability. Two months earlier, more than 100 California consumer groups had written an open letter to six of these lenders, asking them to declare a temporary moratorium on foreclosures for all mortgages issued with inappropriate pricing, such as those increasingly threatening the subprime market. While press reports appeared about both the consumer groups' letter and the lenders' decision, no press report linked the two events in any way. We aren't suggesting lenders willfully ignored the consumer advocacy voice, but note that the attention of reasonable managers in large public enterprises is a finite resource that's compelled to focus on legal compliance and economic incentives.

In the United States today, legal and regulatory oversight is extremely rigorous in publicly traded markets for equity capital. Generally, an enterprise whose reputation is that of an efficient wealth creator will tend to have access to more financial resources to achieve its objectives. Conversely, substantial financial obstacles arise for firms known to disregard legal requirements or ignore the economic conclusions from an objective analysis of demand, pricing, and costs.

Of course, privately owned businesses must comply with legal requirements as well as cover their operating costs and costs of capital, but they usually don't have the same level of governmental oversight and legal responsibility to owners as public enterprises do. Accordingly, Figure 2 shows that, for privately owned companies with relatively low power in stakeholder relationships, we expect a reputation for distributive justice and procedural justice to be the larger contributors toward forming and sustaining important relationships critical to achieving enterprise objectives. It follows that ethics management in these companies will prominently feature these two fairness-based principles.

As enterprise power increases in comparison to its stakeholders' power, such as when it brings unique strength to its relationships, then the enterprise will be able to sustain relationships while keeping more monetary or economic benefit for itself and distributing less to its stakeholders. While stakeholders may not have all their preferences satisfied in this distribution, they are likely to continue their cooperation as long as they have fair access to voice their concerns, protect their interests, and participate in a cordial enterprise decision-making process. For example, small, privately owned retailers don't have resources to pay employees comparably to workers at larger competitors. Yet many small business owners report they attract and retain outstanding employees by offering a greater role in decision making in a more cordial, family-like atmosphere. Accordingly, Figure 2 shows

Table 3: ERM Components Drive Elicitation Dialogue with Stakeholders

#1: INTERNAL ENVIRONMENT	Score the enterprise on the extent to which you believe the following characteristics accurately describe it—trustworthy, honesty, cooperative, integrity.
#2: OBJECTIVE SETTING	Score the enterprise on the extent to which you believe its targets and objectives for the coming period are likely to (a. improve; b. hurt) its relationship with your group.
#6: CONTROL ACTIVITIES	Score the enterprise on the extent to which you believe its policies and procedures ensure it operates in a manner likely to (a. improve; b. hurt) its relationship with your group.
#7: INFORMATION & COMMUNICATION	Score the enterprise on the extent to which you believe its manner of collecting, using, and sharing information is likely to (a. improve; b. hurt) its relationship with your group.
#8: MONITORING	Score the enterprise on the extent to which you believe its manner of detecting violations of operating standards is likely to (a. improve; b. hurt) its relationship with your group.

that for privately owned companies with relatively high power in stakeholder relationships, such as in the employer-employee relationship, we expect a reputation for procedural justice will be the largest contributor toward forming and sustaining important stakeholder relationships.

Risk Management Approach to Reputational Capital

Managing risks to reputational capital requires a sustained dialogue with stakeholders. As Carly Fiorina, former CEO of Hewlett-Packard, recently told an audience at the MIT Sloan School of Management, "[G]ood ethics and good judgment are what must drive business behavior....Employees and customers always know what's wrong." Good ERM practice also means being alert to opportunities. "The corporate reputation is valuable," Jack F. Ward, executive-in-residence at Georgia State University's Southern Institute for Business and Professional Ethics, said at the 2007 Ethics and Governance Conference of the Association to Advance Collegiate Schools of Business. "Avoid a poor ethical climate....Talk to buyers, suppliers, and community groups."

The ERM approach to reputational capital is a process that uses ethical principles as descriptors of enterprise relationships with stakeholders and structures stakeholders' assessments of reputational risks and consequences. We'll now apply the ethical principles to the eight components in the COSO *Enterprise Risk Management—Integrated Framework* to structure dialogue with stakeholders (see Table 2 for a summary).

No matter the context of their governance or negotiating power, all business reputations rely on the fundamental integrity of their personnel to be trustworthy, honest, and cooperative. We capture this in the personal virtue dimension of enterprise reputation, and we ask the stakeholder to score the enterprise on a 1 to 10 scale, where 1 is the lowest and 10 is the highest, according to their perception of the relationship. For the first ERM component, internal environment, the respondent is directed to "Score the enterprise on the extent to which you believe the following characteristics accurately describe it—trustworthy, honesty, cooperative, integrity." (See Table 3.) Dialogue with stakeholders also may elicit the reasons underlying the scores and examples to support their perception of the extent to which principles are applied to action. Table 3 also lists questions to elicit scores for these ERM components: objective setting, control activities, information and communication, and monitoring. Companies may use them to start a dialogue with the stakeholder respondents, and, in the course of this dialogue, additional questions and useful information to assess risk to reputational capital may arise.

We now turn our attention to ERM components three, four, and five: event identification, risk assessment, and risk response. With these components, we group actions into labeled sets according to the significance of their consequences, analyze the likelihood that risks will occur, estimate the impact on enterprise performance if a risk event does occur, and develop a set of actions to mitigate negative consequences. As the middle columns of Table 2 show, the risk manager elicits from the stakeholder a description of future events that, if they were to occur, would change the scores in the stakeholder's earlier responses (columns 1, 2, 6, 7, 8). Then, for each event, the stakeholder estimates the likelihood or probability that it will occur in the forthcoming period. The risk manager then asks the stakeholder to reconsider his or her scores in each cell of columns 1, 2, 6, 7, and 8 with the assumption that each risk event does occur and to estimate the event's consequences in terms of costs and benefits for the enterprise-stakeholder relationship.

Finally, for the events with the greatest expected consequences (i.e., likelihood times benefits, net of costs), the risk manager asks the stakeholder to consider the alternative enterprise responses—avoid the risk, accept it, reduce it, or share it with another party, such as with accommodation from the stakeholder group—and to make a judgment about the likely consequences of each for the relationship.

After completing these tasks for the personal virtue row of the table, the risk manager continues to elicit the stakeholder perceptions for the other ethical principles of legal compliance, economic efficiency, distributive justice, and procedural justice. As discussed earlier, we expect that the risk manager will detect systematic differences in the prominence of ethical principles that arise because of the incentives found in the enterprise. Ownership structures—private or public—and enterprise power relative to the stakeholder (who prevails in bargaining) matter. The table key for Table 2 reminds risk managers to be alert to the full scope of ethical principles that drive stakeholders' judgments and incorporate this broader set in their approach to business ethics excellence (refer to Figure 2).

A Structured Approach Toward Business Ethics Excellence

A risk-management approach to reputational capital becomes truly strategic when it provides:

- Credible and persuasive assurance to senior management—and to the board of directors to whom they are responsible—that the organization is on track to accomplish objectives,
- Reliable monitoring and reporting systems, and
- Activities operating in conformance with the organization's principles.

Shakespeare reminds us in *Hamlet*, however, that "there is nothing either good or bad, but thinking makes it so." Modern business managers may think differently about the appropriate mix of ethical principles given their organizational context and may have diverse stakeholders whose thinking plays significant roles in determining the value and risks to reputational capital.

Obstacles to managing risks to reputational capital include difficulties in identifying and quantifying ethics-based metrics. Further, an enterprise's self-assessment may tend to be inward looking, so the organization may not learn about risks to relationships from the perspective of important stakeholders. Companies can identify and quantify these risks by asking stakeholders how they would assess them if they applied ethical principles to the COSO ERM framework. Accordingly, we suggest more discussion to develop a structured ERM approach toward business ethics excellence that's focused on building reputational capital.

We began this discussion by describing a stakeholder approach to integrating ethics with the components of COSO's ERM framework. We proposed a diagnostic tool to identify the prominent ethical principles embedded in critical relationships and the enterprise context, and we extended the ERM framework to elicit stakeholder assessments of reputational capital. These assessments may identify the expected value of negative consequences, such as direct damages of fines and penalties, cleanup costs including legal and remedial correctives, and costs from damaged relationships with important stakeholders such as customers, employees, suppliers, communities, and government. Positive consequences may include avoiding these negatives, of course, but also may include the expected value of benefits from profit-making activities made feasible by more cooperative and more durable relationships.

We call on ethics managers to use this ERM approach to identify and quantify risks to reputational capital and apply best practices for assuring senior management that the ethical foundations supporting enterprise objectives are well managed. **SF**

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