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ABOUT THE REPORT

Reputation Risk: A Corporate Governance Perspective reports on the Corporate/Investor Summit held by The Conference Board Governance Center in Washington, D.C., in conjunction with the Council of Institutional Investors' annual meeting, in March 2007.

Delegates to the summit agreed about the need for a common base of practical guidance on how boards of directors should address issues involving corporate reputation and business risks threatening reputation capital. This report moves from the recognition of existing literature and major research findings on the subject to discuss the consensus reached by Summit delegates on the oversight role of corporate directors.

Primarily, the report calls attention to the need to embed considerations of corporate reputation into a comprehensive enterprise risk management program. It argues, in particular, that treating reputation risk separately would fundamentally damage those risk management integration initiatives on which many companies have embarked in recent years and impede progress toward a full-fledged approach to business risk that is strategic, holistic, and driven by the top ranks in the organization.

This report focuses on how the board can practically contribute to the integration process. Further empirical research on successful cases where reputation risk was addressed in an integrated risk management context would help identify best practices at the management level. For this purpose, The Conference Board has convened representatives from a selected group of member companies and instituted a Research Working Group on the subject. The group – named “Managing Reputation Risk: Creating Solutions to Evaluate and Manage Your Company’s Reputation Risk” – inaugurates its activities in January 2008.

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Reputation Risk

A Corporate Governance Perspective

by Matteo Tonello, LL.M., Ph.D.



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Introduction

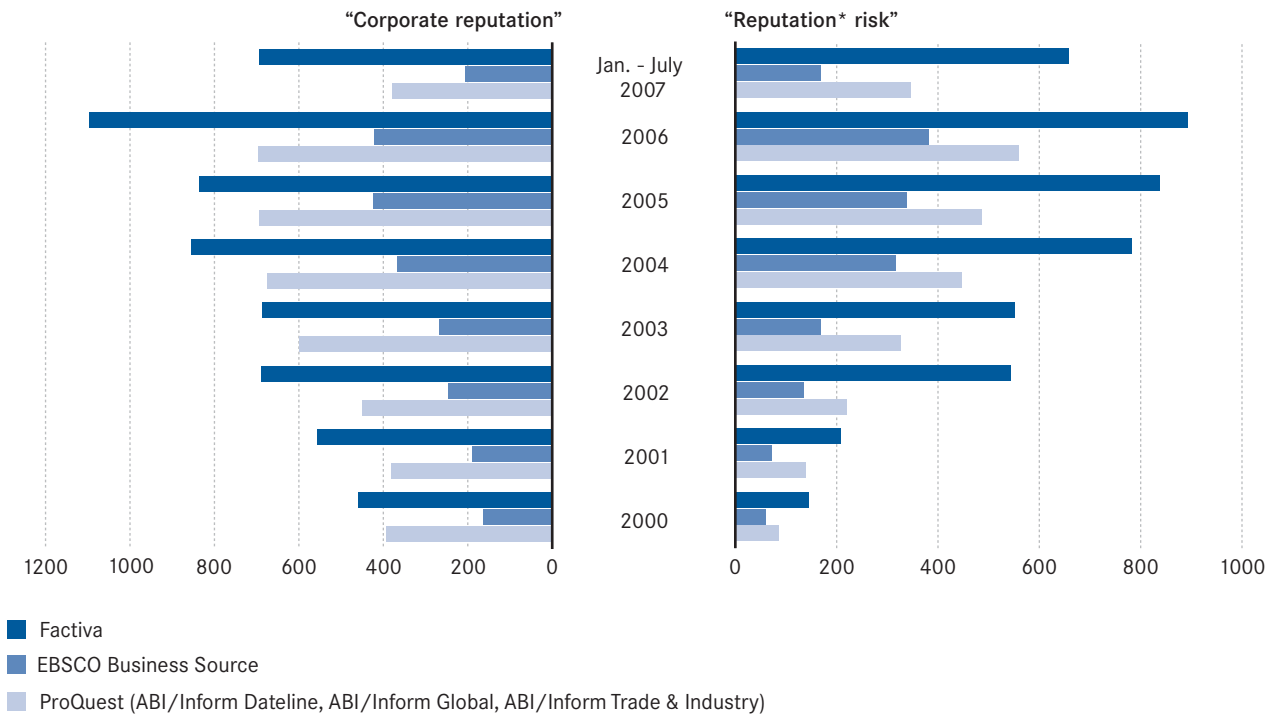
In the last few years, mainly as a result of the erosion of public confidence in business organizations and securities markets, reputation and reputation risk have emerged as significant issues in corporate studies. A search conducted by The Conference Board Business Information Service on business magazine articles and academic journals illustrates that the number of publications containing

(in their title or abstract) the phrases “corporate reputation” and “reputation risk” has more than doubled since the year 2000 (see Figure 1).¹

¹ Also see *Safeguarding Reputation*, Weber Shandwick, No. 1, 2007, p. 1, reporting that media coverage of reputation alone has increased 108 percent over the past five years.

Figure 1

The number of publications containing (in their title or abstract) the phrases “corporate reputation” and “reputation risk” has more than doubled since the year 2000



Source: The Conference Board Business Information Service, July 2007.

The depth of studies in this field is also maturing rapidly.² Research on the relevance of corporate reputation in the current business environment reveals the following:

- In a modern, service-oriented business environment, intangibles, such as corporate reputation, can constitute the bulk of an organization's assets.³
- Public perception of a business positively affects corporate profitability, market-to-book value, and total sales.⁴
- Corporations ranked high in reputation benefit from an average annual stock price increase of 20.1 percent, whereas the shares of the 10 companies ranked lowest in reputation suffered an average annual decline of 1.9 percent.⁵
- About 35 percent of investment decisions are based on factors such as reputation and image.⁶
- In the mergers and acquisitions (M&A) market, a premium is paid for companies with stronger reputation capital.⁷
- Corporate reputation can assist firms engaging in acquisitions and internationalization efforts.⁸
- The smaller the difference among competitors in terms of corporate reputation, the more valuable a unit of reputation in the industry.⁹

² As documented by the expanding array of topics analyzed by *Corporate Reputation Review* (from the definitional aspects of the early years of the journal to the advanced analyses of assessment metrics and extra-financial disclosure standards of the more recent issues) and the worldwide expansion of the Reputation Institute (both founded in 1997).

³ Ibid., p. 2. For additional data, also see Baruch Lev, *Intangibles: Management, Measurement, and Reporting*, Brookings Institution Press, 2001. Lev, of New York University's Stern School of Business, estimates that corporate reputation can comprise more than 60 percent of a company's value.

⁴ P.W. Roberts and Grahame R. Dowling, "Corporate Reputation and Sustained Superior Financial Performance," *Strategic Management Journal*, Vol. 23, 2002, pp. 1077-93.

⁵ M. Qoronfleh and R. Vergin, "Corporate Reputation and the Stock Market," *Business Horizons*, January/February 1998.

Reputation has also become a measure of extra-financial value and business success. Valuation methodologies assign a dollar value to what is acknowledged as an increasingly important intangible asset for an enterprise. During the last decade, market research group Harris Interactive has been applying a reputation quotient methodology to rank U.S. firms with the best and worst reputations.¹⁰ Today, the largest global companies compete to receive prestigious recognitions such as the Reputation Institute's Best Corporate Reputation Award (see Table 1) and *BusinessWeek*/Interbrand's Best Global Brand.

Senior executives and investors are increasingly concerned about the risk of reputation failures. Empirical research shows that:

- Reputation risk is viewed by the majority of executives and investors as the most significant threat posed to a company's global business operations today.
- Senior executives find reputation harder to manage than other types of risks, due to its "amorphous" nature as the risk of risks (i.e., most business risks could have spillover effects on the public's perception of the company).
- Senior executives also find it harder to recover from a reputation failure than to build and maintain reputation. It takes approximately three-and-a-half years for a company to recover from a reputation failure

⁶ *Measures That Matter*, Center for Business Innovation (CBI), Cap Gemini/Ernst & Young, December 1997.

⁷ Based on a survey of 216 Fortune 500 companies conducted by New York University Leonard N. Stern School of Business Management (see www.reputationinstitute.com, 2000).

⁸ Stelios C. Zyglidopoulos, Richard DeMartino, and David McHardy Reid, "Reputation as a Facilitator in the Internationalization of Small and Medium-Sized Enterprises," *Corporate Reputation Review*, Vol. 9, No. 1, pp. 79-87.

⁹ Tomasz Obloj and Krzysztof Obloj, "Diminishing Returns from Reputation: Do Followers Have a Competitive Advantage?" *Corporate Reputation Review*, Vol. 9, No. 4, 2006, pp. 213-224.

¹⁰ The methodology is based on 20 corporate attributes in six categories of public expectations (financial performance, social responsibility, workplace environment, quality of products and services, vision and leadership, and emotional appeal).

Table 1
The World's Most Reputable Companies

RepTrak Rank 2006	Company	Country	Industry	RepTrak Pulse 2006	2005 Revenues (\$mil)
1	Barilla Holding	Italy	Food & Tobacco	87.79	5,522**
2	LEGO Holding A/S	Denmark	Consumer Products	86.58	1,380
3	Deutsche Lufthansa AG	Germany	Airline & Aerospace	84.09	21,353
4	IKEA International A/S	Sweden	Retail - General	84.08	18,088
5	Compagnie Generale des Etablissements Michelin	France	Automotive	83.79	18,428
6	Toyota Motor Corp.	Japan	Automotive	83.15	179,024
7	A.P. Moller-Maersk A/S	Denmark	Transport/Logistics	83.15	33,058
8	Ferrero SpA	Italy	Food & Tobacco	82.98	5,664**
9	Samsung Electronics Co. Ltd.	South Korea	Electrical & Electronics	82.57	79,501
10	Kraft Foods Inc.	USA	Food & Tobacco	81.82	34,113
11	Danfoss A/S	Denmark	Industrial Products	81.57	2,860
12	AKER	Norway	Industrial Products	81.33	9,710*
13	Johnson & Johnson	USA	Pharmaceuticals	81.07	50,514
14	Koninklijke Philips Electronics N.V.	Netherlands	Electrical & Electronics	80.98	35,928
15	Federation of Migros Cooperatives	Switzerland	Retail - Food	80.91	17,938**
16	Reitangruppen AS (Rema 1000)	Norway	Retail - Food	79.71	2,496*
17	Tesco PLC	UK	Retail - Food	79.65	69,218
18	BMW AG	Germany	Automotive	79.58	55,149
19	Honda Motor Co. Ltd.	Japan	Automotive	79.55	84,317
20	Tata Group	India	Conglomerate	79.41	17,878*
21	Aldi Group	Germany	Retail - Food	79.18	37,000
22	VELUX A/S	Denmark	Industrial Products	78.92	2,209
23	PepsiCo Inc.	USA	Beverage	78.85	32,562
24	Novo Nordisk A/S	Denmark	Pharmaceuticals	78.75	5,351
25	Haier Group	China	Electrical & Electronics	78.74	12,800
26	Kone Corp.	Finland	Industrial Products	78.73	7,182*
27	Walt Disney Co.	USA	Information & Media	78.65	31,944
28	McCain Foods	Canada	Food & Tobacco	78.03	4,623*
29	Mercadona, S.A.	Spain	Retail - Food	78	11,962**
30	Grupo Bimbo, S.A.	Mexico	Food & Tobacco	77.86	5,206*
31	Luxottica Group	Italy	Consumer Products	77.68	5,578
32	Coop Norge AS	Norway	Retail - Food	77.63	2,921*
33	Coop Italia	Italy	Retail - Food	77.44	15,000
34	Airbus S.A.S.	France	Airline & Aerospace	77.41	28,313
35	Raiffeisen Bank	Switzerland	Financial - Diversified	77.37	3,034*
36	Robert Bosch GmbH	Germany	Electrical & Electronics	77.26	49,759
37	Grupo Leche Pascual, S.A.	Spain	Food & Tobacco	77.06	1,353**
38	Canon Inc.	Japan	Electrical & Electronics	77.02	31,798
39	Woolworths Ltd.	Australia	Retail - Food	76.98	28,034
40	Home Depot Inc.	USA	Retail - General	76.95	81,511
41	Nokia Corp.	Finland	Telecommunications	76.85	40,415
42	Vestas Wind Systems A/S	Denmark	Industrial Products	76.8	4,243
43	Woolworths Holdings Ltd.	South Africa	Retail - General	76.78	2,100**
44	Grundfos A/S	Denmark	Industrial Products	76.71	2,079
45	Marks & Spencer Group PLC	UK	Retail - General	76.66	13,561
46	Ebro Puleva S.A.	Spain	Food & Tobacco	76.6	2,615**
47	Sharp Corp.	Japan	Electrical & Electronics	76.38	23,803
48	Sol Meliá, S.A.	Spain	Services	76.33	1,416**
49	3M Co.	USA	Industrial Products	76.27	21,167
50	L'Oreal S.A.	France	Consumer Products	76.12	17,178

Source: Reputation Institute, 2006. Revenues are from the 2005 Forbes 1000 or company websites except where noted.

* 2005 revenues from Hoovers.com. ** 2004 revenues from Hoovers.com

and companies with strong track records for corporate responsibility find it easier to recover.

- Most CEOs admit that their companies lack coordination with respect to who owns reputation risk, and responsibilities are fragmented among a wide range of business managers.
- There is debate on how reputation risk should be categorized and addressed, whether as a separate and distinct category of risk or simply one of the effects of operational incidents.
- Despite the variety of techniques now available to quantify reputation risk (e.g., Reputation Quotient,¹¹ AC2ID test,¹² Personification Metaphor,¹³ etc.), companies and investors still do not agree on a common set of metrics.¹⁴

¹¹ Reputation Quotient (or RQ) measures the perception of external groups that do not necessarily have any direct relationship with the organization (or any direct consequence on it). See Charles J. Fombrun, et al., "The Reputation Quotient SM: A Multi-Stakeholder Measure of Corporate Reputation," *Journal of Brand Management*, Vol. 7, No. 4, 1999, pp. 241-255.

¹² AC2ID is a discrepancy-analysis test formulated to assess the gap between "corporate identity" and "corporate reputation" (see p. 43 for the distinction) by John M.T. Balmer, "From the Pentagon: A New Identity Framework," *Corporate Reputation Review*, Vol. 4, No. 1, 2001, pp. 11-22.

¹³ Another discrepancy-analysis test, the Personification Metaphor was developed by Gary Davies, et al., "The Personification Metaphor as a Measurement Approach for Corporate Performance," *Corporate Reputation Review*, Vol. 4, No. 1, 2001, pp. 113-127.

¹⁴ *Reputation: Risk of Risks*, Economist Intelligence Unit, December 2005. Data are based on a survey of 265 senior executives of publicly traded corporations. Sixty-two percent of respondents said reputation risk is harder to manage than other types of business uncertainties, whereas 52 percent indicated that reputation risk is the most significant threat posed today to their organization's global business operations. Also, 84 percent of the 950 executives surveyed worldwide in 2007 by consulting group Weber Shandwick and KRC Research reported that reputation risk has increased significantly over the last five years, while 66 percent believe that it is harder to recover from reputation failure than it is to build and maintain reputation. See *Safeguarding Reputation*, Weber Shandwick, Issue No. 1, 2007, pp. 2-3.

Despite the recent surge in research and interest, corporate reputation remains a highly disjointed field of study. The existing literature is primarily management-focused,¹⁵ and there is still very little discussion among scholars and experts on the oversight function of the board in protecting and enhancing this corporate asset.

Reputation Risk: A Corporate Governance Perspective reports on the Corporate/Investor Summit held by The Conference Board Governance Center in Washington, D.C., in conjunction with the Council of Institutional Investors' annual meeting, in March 2007. The report is intended to increase the awareness of reputation risk as a corporate governance matter and offer guidance on how corporate boards can approach their fiduciary responsibilities in this area. Corporate governance is the system of checks and balances instituted by the board of directors to ensure that an organization is suited to meet its business objectives, not the interests of insiders. Since corporate reputation is the perception of the firm by a variety of stakeholders, board members should consider having an organizational program in place to oversee any material event that may affect stakeholder relations so as to ensure that such events do not compromise the company's ability to achieve its long-term goals.

¹⁵ A number of comprehensive manuals for senior managers are available in the market. See, for example, Arif Zaman, *Reputational Risk. How to Manage for Value Creation*, Pearson, 2003; and Jenny Rayner, *Managing Reputational Risk: Curbing Threats, Leveraging Opportunities*, John Wiley & Sons, 2003.

Key Recommendations

The report discusses the following recommendations for corporate boards:

- Boards of directors should reach a common understanding of the concept of corporate reputation and tie its discussion to a comprehensive analysis of the firm's stakeholder base. Corporate reputation oversight represents a formidable strategic opportunity to strengthen stakeholders' relations that pertain to the company's long-term business objectives.
- Directors should familiarize themselves with management's rationale for prioritizing stakeholder relations and be persuaded that the selected relations are instrumental in achieving the company's long-term objectives. In doing so, directors should be aware that executives and other insiders might attribute varying degrees of importance to the same group of stakeholders, according to the degree of interactions they have had with said group or the potential private benefit they may derive from certain relations.
- Boards should discuss and understand the nature of reputation risk as an effect of certain business operational incidents, not as a separate and distinct category of uncertainties. Accordingly, directors should consider objecting to the establishment of a dedicated organizational platform to address reputation risk, as it would conflict with current risk management integration best practices and retard the development of a full-fledged enterprise risk management (ERM) program. Failure to embed reputation risk into ERM could lead to inefficiencies and disparities in the company's response to risk events; in addition, it could undermine the firm's ability to foster a cohesive culture of risk awareness.
- Directors should oversee the design and implementation of a strategic, top-down, and holistic risk management program where all business events with potential consequences to the firm's reputation capital are identified, measured vis-à-vis tolerance levels and appetite for risk, and addressed in a timely manner. ERM enables the company to elevate relevant reputation issues to the board level, where they can be analyzed strategically for their potential impact on long-term shareholder value.
- Boards of directors should consider adhering to The Conference Board Road Map to Risk Governance¹⁶ to embed reputation risk oversight into a comprehensive risk management program. Specifically, the board should ensure that such ERM phases as the risk portfolio compilation, assessment, and response strategy determination do not disregard potential effects of business risk events on reputation capital.
- The board of directors should oversee the process adopted by senior executives to identify, categorize, and prioritize business uncertainties with respect to their reputation effects. Directors should ensure that prioritization criteria and other techniques used in compiling a risk portfolio comprise, among others, a set of reputation metrics. Specifically, the inclusion of a risk event in the portfolio should also be decided based on the likelihood and impact of the event consequences on the company's reputation capital.
- The board should oversee the determination of a proper response strategy to each risk category affecting corporate reputation.

¹⁶ See p. 28 for a description.

Response strategies should be assessed, among other things, on the basis of a resource cost-benefit analysis. Directors should be skeptical of attempts at restoring stakeholder confidence solely through the use of savvy communication tactics, and request instead that response strategies fully address the underlying operational risks. In a well-designed ERM program, communication tactics and better disclosure should be seen as tools to corroborate and complete a business risk response strategy, not to replace it.

The discussion of these recommendations is supplemented by references to a number of practical cases of corporate reputation failures and reputation risk management (see Appendix I: “Case Studies,” on p. 43, for an overview of each case).

Reputation Risk: A Corporate Governance Perspective is also a complement to *The Role of U.S. Corporate Boards in Enterprise Risk Management* and *Emerging Governance Practices in Enterprise Risk Management*, two recent research reports from The Conference Board, illustrating risk oversight practices adopted by leading boards of directors in the United States.¹⁷

Through these and other research projects on risk governance, The Conference Board Governance Center continues to address the multifaceted issue of stock market short-termism according to the recommendations made by delegates to the Corporate/Investor Summit held in London in July 2005. Undoubtedly, the increasing focus on short-term, purely financial results shown in recent years by many securities market participants (including company executives, fund managers, and research analysts) has led to a reduction of focus on long-term responsibility issues and the well-documented erosion of public confidence in corporations.¹⁸

Business risks affecting corporate reputation capital should therefore be addressed as part of an integrated program on risk management that is strategic, holistic, and driven by the top ranks in the organization (primarily the corporate board and senior executives). In the view of delegates to the July 2005 Corporate/Investor Summit: “Widespread adoption of an enterprise risk management framework should be encouraged as an effective process to assess and respond to strategic and operating risk, not only to bring clarity to the long-term strategic direction a business should take, but also to clearly communicate such long-term strategy to the market.”¹⁹

¹⁷ Carolyn Kay Brancato, Matteo Tonello, and Ellen Hexter, *The Role of U.S. Corporate Boards in Enterprise Risk Management*, The Conference Board, Research Report, R-1390-06-RR; and Matteo Tonello, *Emerging Governance Practices in Enterprise Risk Management*, The Conference Board, Working Group Report, R-1398-07-WG.

¹⁸ *Findings and Recommendations*, The Conference Board Commission on Public Trust and Private Enterprise, The Conference Board, Special Report 4, 2003.

¹⁹ Matteo Tonello, *Revisiting Stock Market Short-Termism*, The Conference Board, Research Report, R-1386-06-RR, p. 43.

One, Two, Many Reputations...

The Strategic Need for Corporate Reputation Oversight

Boards of directors should reach a common understanding of the concept of corporate reputation and tie its discussion to a comprehensive analysis of the firm's stakeholder base. Corporate reputation oversight represents a formidable strategic opportunity to strengthen stakeholders' relations that pertain to the company's long-term business objectives.

Despite the recent surge in research on the topic, corporate reputation remains a highly disjointed field of study. An overview of academic literature and business publications on corporate reputation reveals a lack of cohesiveness and considerable disparity in the terminology used by scholars and risk managers. For example, there is very little agreement on the meaning of fundamental terms such as business identity, image, and reputation, which are often used interchangeably (see Identity, Image, Reputation, and Reputation Capital on p. 12).²⁰

"Reputation" is the perception of the corporation by the public, and it is a function of triggering events that reveal to the public a previously unknown corporate practice or a new fact regarding products and services sold by the firm. A common understanding of this concept is pivotal to any fruitful discussion on the practical role that the board can play in overseeing the protection and enhancement of the company's reputation.

Since it is subject to changes in perception by a broad variety of stakeholders, corporate reputation is a relative and dynamic concept and may be difficult to capture. First of all, a fact regarding the business or the behavior of an executive may be judged differently by different corporate stakeholders, according to their business culture, set of moral values, and relationship with the firm. As a result, expectations can shift over time (for example, with the changing of the underlying regulatory environment in which a stakeholder operates) or according to the region or country where a group of interests is based.²¹ Furthermore, in forming their own impression about a business entity, some stakeholders may be more sensitive to the company's financial achievements; others may pay attention to the corporation's solvency and capacity to serve its debt obligations; and still others may care about the social or environmental impact of the company's strategy.

Therefore, corporate reputation affects stakeholders' inclination to be engaged with a certain company (through a supply relationship, a customer relationship, an employment relationship, or simply by deciding to live in the local community where the company has operations) and a company's public support in

²⁰ For an analysis of the various definitions published over the years, see Charles J. Fombrun, et al., "The Reputational Landscape," *Corporate Reputation Review*, Vol. 1, No. 1/2, 1997, pp. 5-13; and, by the same authors, "Corporate Reputation," in N. Nicholson (ed.), *Blackwell Encyclopedic Dictionary of Organizational Behavior*, Blackwell Publishers, 1998. On identity, image, and reputation, see John M.T. Balmer and Stephen A. Greyser, *Revealing the Corporation: Perspectives on Identity, Image, Reputation, Corporate Branding and Corporate-Level Marketing*, Routledge, London-New York, 2003, p. 352.

²¹ For an empirical study of cross-cultural differences in corporate reputation, see Naomi A. Gardberg, "Reputatie, Reputation, Réputation, Ruf: A Cross-Cultural Qualitative Analysis of Construct and Instrument Equivalence," *Corporate Reputation Review*, Vol. 9, No. 1, 2006, p. 39.

times of controversy. For these reasons, members of the board should tie any discussion on the firm's reputation to a comprehensive analysis of the business constituencies and ensure that the organization does not neglect its key stakeholder relations.

The link between corporate reputation and the company's constituencies reveals the long-term strategic value of the reputation oversight function that the board can perform. In a complex and global marketplace, corporate reputation is as diverse and multifaceted as the company's stakeholder base. Organizations strive to reconcile different expectations and rigorously maintain one public impression about who they are. For example, multinational organizations operating in a myriad of foreign markets must be able to adhere rigorously to home country and international standards in spite of different domestic practices in such sensitive areas as participation in local political activities, relations with public officials (in some

countries with high degrees of business corruption, public officials may expect to be compensated by corporate officers to perform their public duties), retaliation practices against whistle-blowers, the employment of underage workers, etc.

The pressure to generate short-term financial returns that is placed upon companies by some shareholders and financial research analysts must be balanced against fundamental choices about the type of recognition the company wants to receive from present and future generations. At times, strengthening or even simply cultivating a relationship with all stakeholders might be impossible. This is where the company should realize the strategic opportunity of corporate reputation and reputation risk management and choose to invest on enhancing its relations with those stakeholders whose support is crucial to the business' long-term objectives.

Identity, Image, Reputation, and Reputation Capital

"Identity" is the true essence of the corporation (its defining attributes, such as its mission, strategy, core ethical values, organizational culture, and business practices). Insiders (mainly board members and senior executives) are often the only individuals who are privy to the company's true identity. By the same token, a corporate identity is primarily a function of the perception and knowledge of the organization by those insiders.

"Image" is how the corporation represents itself to the public; as such, corporate image is a function of mandatory disclosure, public relations, marketing (branding and advertising) efforts, and other organizational initiatives that attempt to shape the impression people have of the firm. Images can be manipulated; since corporations may have a disincentive to accurately display their identity (and its possible pitfalls), corporate image can serve as a powerful tool to fictitiously bridge the gap between the actual knowledge that an insider has of the firm and its perception by outsiders.

"Reputation" is the perception of the corporation by the public (including the corporation's various stakeholders such as suppliers, customers, employees, local communities, etc.), and is a function of certain events exposing a corporate identity feature (a business practice, a behavioral incident, or a characteristic of the products sold) that was previously unknown to the public.^a

"Reputation capital" is the perception of the corporation by those stakeholders whose relationship with the corporation is directly instrumental to the pursuit of long-term growth and shareholder value. The term "residual reputation" is often used to refer to those stakeholder relations that do not affect shareholder value and are not comprised by reputation capital.

^a See Michael L. Barnett, John M. Jermier, and Barbara A. Lafferty, "Corporate Reputation: The Definitional Landscape," *Corporate Reputation Review*, Vol. 9, No. 1, 2006, pp. 26-38 (where corporate reputation is defined as the "Observers' collective judgments of a corporation based on the assessments of the financial, social, and environmental impacts attributed to the corporation over time").

A Stakeholder Base Analysis of Corporate Reputation

Directors should familiarize themselves with management’s rationale for prioritizing stakeholder relations and be persuaded that the selected relations are instrumental in achieving the company’s long-term objectives. In doing so, directors should be aware that executives and other insiders might attribute varying degrees of importance to the same group of stakeholders, according to the degree of interactions they have had with said group or the potential private benefit they may derive from certain relations.

The stakeholder theory of the business corporation holds that a firm should be analyzed with regard to its key-interest constituencies. This approach is also important in understanding the concept of “reputation capital,” which is a subcomponent of corporate reputation. Reputation capital correlates not to the public at large but only to those stakeholder relationships that are instrumental to the company’s pursuit of long-term shareholder interest (see Reputation Risk Oversight Determinants on p. 14). As such, reputation capital is quantifiable in dollar value. It is the concept of reputation capital – with its economic connotation as a shareholder value enhancer – that places reputation risk management within the boundaries of directors’ and officers’ fiduciary duties.

In adopting a stakeholder approach to reputation management, executives should first identify the key stakeholder relations for the company. The following relations should be considered:

Enabling relations Shareholders, bondholders, banks, institutional investors, suppliers, and employees are key stakeholders because they provide and control resources enabling the organization to exist and operate.

Customer relations Customers are key stakeholders because they provide demand for business output.

Normative relations Professional associations, trade unions, legislatures, governmental agencies, financial analysts, rating agencies, and other self-regulatory organizations may be key stakeholders as they

function as standard-setters and determine the boundaries of the company’s business activities.

Peer relations Other business organizations (including competitors) may be key stakeholders if they participate in a joint venture, a non-compete agreement, or other strategic relationships with the company.

Special interest relations Local communities and a number of activist groups (such as social and environmental organizations) may be key stakeholders as they have diffused interest in and claims on the company.²²

Once key stakeholder relations have been identified and categorized, management should analyze them from a situational and contextual point of view, so as to prioritize groups of stakeholders based on criteria including: their actual influence; the criticality, rationality, and urgency of their claims; their access to and control of key business resources; and the likelihood of their taking supporting action.²³ Paradoxically, from this analysis a company might even conclude that a relation with a certain group of stakeholders should be weakened or severed rather than strengthened because the association with that group would, in fact, damage corporate reputation. This is what

²² Based, in part, on a categorization by Laura Illia and Francesco Lurati, “Stakeholder Perspectives on Organizational Identity: Searching for a Relationship Approach,” *Corporate Reputation Review*, Vol. 8, No. 4, 2006, pp. 293-304.

²³ *Ibid.*, p. 300.

occurred just a few years ago in response to the financial scandals that marred the reputation of certain outside auditors, financial advisers, and other market intermediaries.²⁴

Developing a strategy for enhancing and protecting corporate reputation requires a cautious resource allocation decision, which should be made in light of the organizational and industry context in which the firm operates.²⁵

²⁴ For a discussion of the spillover effects on clients of reputation issues of audit firms and other intermediaries, see Renate Hecker, Alexander Krieg, and Andreas Pfauth, "The Effect of Auditor Reputation on Stock Returns – The Case of Arthur Andersen," University of Tuebingen Working Paper, October 2006; Jayant R. Kale, Omesh Kini, and Harley E. Ryan, Jr., "On the Participation and Reputation of Financial Advisors in Corporate Acquisitions," Center for Research in Financial Services Working Paper Series, July 1998; and Sharad C. Asthana, Steven Balsam, and Jagan Krishnan, "Audit Firm Reputation and Client Stock Price Reactions: Evidence from the Enron Experience," Temple University Working Paper, June 2003.

If correctly implemented, a stakeholder approach also functions as a feedback system for the purpose of forming or revisiting the core identity of the firm in those situations where board members realize that managers may be induced to short-term manipulations (including possible accounting frauds and financial misstatements) to avoid unveiling the gap between the firm's organizational reality and its reputation.²⁶

The role of the board is to oversee the shareholder base analysis and ensure that it is transparent and thorough. Specifically, directors should become familiar with the rationale for the prioritization and be persuaded by the effectiveness of the strategies developed by manage-

²⁵ See Westcott Alessandri and Todd Alessandri, "Promoting and Protecting Corporate Identity: The Importance of Organizational and Industry Context," *Corporate Reputation Review*, Vol. 7, No. 3, 2004, pp. 252-268.

²⁶ Robert G. Eccles, Scott C. Newquist, and Roland Schatz, "Reputation and Its Risks," *Harvard Business Review*, February 2007.

Reputation Risk Oversight Determinants

What are the factors driving reputation risk oversight and governance? Corporate reputation is perhaps the single, most important intangible asset held by a company as it represents the extent to which the organization is meeting the expectations of its various constituents. The reputation of a company translates into a competitive advantage, is closely linked to its profitability, and, ultimately, affects shareholder value. Thus, corporate fiduciaries should be sensitive to reputation issues for the same reasons they should care about:

- The attitude of local communities in which the company operates;
- The evaluation by judges and juries hearing a lawsuit involving the company;
- The satisfaction and fidelity of customers;
- The ability of the organization to recruit and retain talented employees and access crucial operating resources;

- The policy-making decisions of regulators and legislators;
- The ability of the organization to establish strategic relationships with third parties (i.e., supply agreements, joint ventures, etc.);
- The ability of the organization to raise capital and finance acquisitions;
- The positive inclination of media towards the company.

Sources: Bryan Dumont, Understanding Your Most Valuable Asset: The Growing Importance of Measuring Corporate Reputation, Presentation to The Conference Board Corporate/Investor Summit, March 2007; Reputation Insight. Gaining a Deeper Understanding of Reputation, Presentation to The Conference Board European Council on Corporate Governance, Brussels, June 14, 2007; and Abraham Carmeli and Asher Tishier, "Perceived Organizational Reputation and Organizational Performance: An Empirical Investigation of Industrial Enterprises," *Corporate Reputation Review*, Vol. 8, No. 1, 2005, pp. 13-30. On the link between corporate reputation and shareholder value, see p. 39 of this report.

ment to maintain and strengthen those relationships that are deemed crucial to the company's long-term agenda. As part of their analysis, directors should be aware not only that different groups of stakeholders have different perceptions of the firm but also that insiders may attribute different importance to the same group of stakeholders, according to the degree of interaction they have with the group. For example, sales personnel are naturally more sensitive to customer satisfaction issues than the company's purchasers, who care primarily about the suppliers' view of the organization; thus, the components of corporate reputation of importance to sales and purchasing may differ from those regarded as essential by senior executives. By gathering information from a variety of ranks in the organization, the board should try to develop an informed opinion on all of these perspectives.²⁷

Summit delegates shared the following considerations with respect to the role of the board of directors in overseeing the company's relationship with stakeholders for reputation purposes.

Shareholders and Prospective Investors as Stakeholders

As discussed above, under the stakeholder theory of the firm, a business corporation is a nexus of relations and should conduct its activities by balancing a variety of key stakeholders' interests. This multidimensional construct is particularly useful in examining the components of corporate reputation and developing a comprehensive reputation protection strategy, but does not exempt board members and senior executives from their fiduciary duties to the business owners. Thus, shareholders must be central to any stakeholder base analysis.

Research shows that corporate reputation is an indicator of equity value, and reputable firms are more likely to sustain superior financial and market performance over time. Specifically, studies show that corporations ranking high in reputation are seen to benefit from an average annual stock price increase of 20.1 percent, whereas publicly traded shares of a list of 10 companies ranked at the bottom in reputation suffered an average annual decline of 1.9 percent.²⁸ In addition, it is proven that strong reputation reflects on the economics of corporate transactions: more precisely, it lowers transaction costs for all parties to the transaction and commands higher price premiums to the advantage of the reputable party.²⁹

The role of the board is to ensure that this positive correlation between reputation and stock performance is not undermined by factors such as:

- Excessive external pressures (for example, by research analysts or certain speculative investors) to generate short-term financial results.
- Inadequate executive compensation plans, which function as disincentive to pursue a sustainable reputation capital growth strategy.

²⁷ Abraham Carmeli, Gershon Gilat, and Jacob Weisberg, "Perceived External Prestige, Organizational Identification and Affective Commitment: A Stakeholder Approach," *Corporate Reputation Review*, Vol. 9, No. 1, 2006, pp. 92-104.

²⁸ M. W. Qoronfleh and Roger C. Vergin, "Corporate Reputation and the Stock Market," *Business Horizons*, January/February 1998; Sam Y. Chung, Kristina Eneroth, and Thomas Schneeweis, "Corporate Reputation and Investment Performance," *Research in International Business and Finance*, Elsevier Science, Vol. 17, pp. 273-291; Sudhir Nanda, Thomas Schneeweis, and Kristina Eneroth, "Corporate Performance and Firm Perception: The British Experience," *European Financial Management*, Vol. 2, No. 2, 1996, pp. 197-221; Jason Perry and Patrick de Fontnouvelle, "Measuring Reputation Risk: The Market Reaction to Operational Loss Announcements," Federal Reserve Bank of Boston Working Paper, October 2005.

²⁹ Tomasz Obloj and Krzysztof Obloj, "Diminishing Returns From Reputation: Do Followers Have a Competitive Advantage?" *Corporate Reputation Review*, Vol. 9, No. 4, 2006, p. 221.

- Lack of transparency and financial accountability, due to flawed shareholder disclosure procedures, poor investor relations, or insufficient communication of extra-financial measures of performance.³⁰

Without question, the reputation of a firm cannot rely on financial results alone. However, a point that boards should consider in their stakeholder base analysis of corporate reputation is that there are a growing number of studies illustrating how an excessive emphasis by the business (in public disclosures as well as in communication and marketing initiatives) on financial performance may have a backlash effect on the firm's consumer market by eroding brand appreciation and, ultimately, damaging customer satisfaction.³¹

This data confirms that the pursuit of shareholder value is a multidimensional venture and should take into account the whole complexity of interests in which the business operates (i.e., the treatment of customers, staff, and the wider community).

Customers as Stakeholders

Interestingly, the relationship with customers may be only marginally affected by the reputation of the corporation as a whole. In a variety of business sectors, and especially in the consumer goods industry, what really nurtures the relationship with customers is a powerful and reliable product brand.

Since customers may remain unaware of (and even be uninterested in) the maker of their favorite products (many, for example, do not know that Ferrari is a Fiat brand or that Mercedes is made by Daimler), companies in those sectors and with multiple brands may not feel the need to associate the product with the brand's owner by investing in overall corporate reputation. Moreover, they may conclude that the lack of a unitary perception of the manufacturing firm would help to isolate the negative effects of a single brand's potential deterioration in the consumer market. From this point of view, minimizing corporate visibility and reputation can be a conscious risk differentiation (and risk management) strategy.

However, there are a few notable examples of business models (e.g., Anita Roddick's Body Shop),³² where the overall reputation of an organization – including the recognition for how certain ideals and beliefs influence the firm's production processes, human resource selection, and working style – is strategically deployed to appeal to that segment of the population that identifies itself with those beliefs and ideals. In other cases, overall corporate reputation can operate as a cohesive franchise and lend credibility to new products or ventures (e.g., the strategy pursued by CEO Steve Jobs to leverage Apple's reputation as a designer of sleek, cutting-edge, and alternative computer technology in order to create new expectations in the minds of consumers and make a dent in the music distribution and wireless communication industries).

³⁰ For a discussion of these issues, see Matteo Tonello, *Revisiting Stock Market Short-Termism*, p. 18. Also see, Dean Krehmeyer, Matthew Orsagh, and Kurt N. Schacht, *Breaking the Short-Term Cycle*, CFA Institute/Business Roundtable Institute for Corporate Ethics, 2006; *Long-Term Value Creation: Guiding Principles for Corporations and Investors*, The Aspen Institute, June 2007; *Built to Last: Focusing Corporations on Long-Term Performance*, Committee for Economic Development, 2007; *Enhancing America's Long-Term Competitiveness: Ending Wall Street's Quarterly Earnings Game*, U.S. Chamber of Commerce, November 2005.

³¹ See Don Porritt, "The Reputation Failure of Financial Success: The 'Bottom Line Backlash' Effect," *Corporate Reputation Review*, Vol. 8, No. 3, 2005, p. 198, on distinguishing between "relationship reputation" (the treatment of customers, staff, and the wider community) and "bottom-line reputation" (delivering on the expectations of investors and financial markets). Also see Manfred Schwaiger, "Components and Parameters of Corporate Reputation – An Empirical Study," *Schmalenbach Business Review*, Vol. 56, January 2004, p. 46. The author describes reputation as a two-dimension phenomenon, with a cognitive component he calls "competence" and an affective one he calls "sympathy." The study shows that performance aspects drive competence but dampen sympathy.

³² For an analysis of the role played by Ms. Roddick's reputation as a concerned environmentalist in the implementation of The Body Shop business model, see Paul A. Argenti and Bob Druckenmiller, "Reputation and the Corporate Brand," Tuck School of Business at Dartmouth Working Paper No. 03-13, available at <http://www.ssrn.com/abstract=387860>.

Boards should consider requesting regular information from management on customer satisfaction and “fidelization” (i.e., survey findings, market analyses, internal assessments, etc.) and determining whether maintaining a low-key corporate profile among customers is a valid reputation risk management strategy. Empirical research shows that, despite the lack of an association between brand and manufacturer, companies who can also rely on a solid corporate reputation proposition are better suited to face a situation of reputation crisis. A notable example is that of Johnson & Johnson, which was able to regain 95 percent of its market share within three months of its Tylenol/cyanide crisis, in the early 1980s.³³

Employees as Stakeholders

Studies show that a favorable perception of the firm by the public reflects on corporate staff as well, by fostering a positive attitude in the performance of its functions. Specifically, a strong corporate reputation plays on employees’ desire to enhance their self-esteem and social status by sharing the prestige of being part of a highly regarded group. As a result, it tends to augment employees’ cognitive identification and commitment towards the organization they are affiliated with and increase the company’s ability to attract and retain talented individuals.³⁴

A civil workplace centered on business ethics and a culture of integrity is also crucial to the employees’ impression about the company. As they work in the organization, employees are more knowledgeable

about the true identity of the firm than other category of stakeholders. A company can hardly shield from its personnel any significant gap between corporate identity, known to insiders, and public reputation – a gap that inevitably translates into employee dissatisfaction and skepticism about the business. Therefore, the most valuable contribution that the board can provide is to oversee the establishment, implementation, and effectiveness of a rigorous compliance and ethics program, inclusive of a set of anonymous whistle-blowing procedures, to foster a climate of transparency and accountability at every level of the organization.³⁵

Also, since employees often participate in share distribution plans and own equity in the company, they pay increasing attention to issues of financial performance. In order to protect the company’s reputation among its own human resources, boards should consider ensuring that employees receive objective and unbiased information on corporate performance directly from senior management. In addition, employees should be able to ask questions and receive satisfactory answers on any worrisome report published by a third party, such as business media and securities analysts, especially if such analyses divert from the company’s MD&A and the internal information disseminated by executives and investment plan providers.

³³ See Appendix I (“Case Studies,”) on p. 43.

³⁴ Abraham Carmeli and A. Freund, “The Relationship Between Work and Workplace Attitude and Perceived External Prestige,” *Corporate Reputation Review*, Vol. 5, No. 1, 2002, pp. 51-68. Also see N. Ellemers, P. Kortekaas, and J.W. Ouwerkerk, “Self-Categorization, Commitment to the Group and Group Self-Esteem as Related but Distinct Aspects of Social Identity,” *European Journal of Social Psychology*, Vol. 29, No. 2-3, 1999, pp. 371-389; Marjorie K. Shelley and Hongmei Zhao, “The Effects of Group Identification and Decision Disclosure on Individuals’ Decisions to Incur Personal Cost to Reduce Group Risk,” University of Illinois Working Paper, April 2006.

³⁵ For an overview of best practices in ethics and compliance oversight, see Matteo Tonello and Carolyn K. Brancato, *Corporate Governance Handbook 2007. Legal Standards and Board Practices*, The Conference Board, R-1405-07-RR, 2007, pp. 86-99.

Table 2
Example of Advanced Stakeholder Expectation Analysis for a Chemical Company

CONSUMERS	Product Quality	Produces useful chemical products
		Produces chemicals used to develop products that provide greater value for consumers
		Produces chemicals that make products we use better
	Safety Research and Testing	Invests in research and development to create high quality products for consumers
		Conducts ongoing research on the possible effects of chemicals on human health
		Conducts ongoing research on the possible effects of chemicals on the environment
		Cooperates with government, non-profits and universities to research the long-term possible health effects of chemicals on human health
		Invests in research to determine if chemicals have a particular impact on children
	Information and Education	Assures that research on chemicals is unbiased and factual
Conducts thorough safety tests before putting products on the market		
Provides easily understandable information about its products		
Makes sure that labels and instructions for use are easy to understand		
PRODUCTION PROCESS	Production Safety	Ensures that products made from chemicals offer warnings and instructions for safe use
		Promotes the safe use of chemical products by consumers
		Establishes standards for plant security that go beyond what is required by law
		Takes steps so that other companies who make things with chemicals use chemicals properly
	Worker Safety	Ensures that plants continually update equipment and technology
		Supports monitoring of manufacturing plants by independent safety experts
		Establishes standards for safe transport of chemicals that go beyond what the law requires
	Accident Response	Fosters a safe and healthy work environment
		Provides plant employees with regular safety training
		Equips workers with knowledge and equipment to keep them safe
		Provides ongoing medical monitoring of plant workers exposed to chemicals
		Immediately informs government authorities and the local community if plant accidents occur
		Supports emergency response teams that can respond quickly in the event of an accident

continued on next page

Table 2 continued

Example of Advanced Stakeholder Expectation Analysis for a Chemical Company

COMMUNITY INVOLVEMENT	Community Engagement	<p>Informs local communities about the specific chemicals being produced at nearby plants</p> <p>Meets with local community officials to plan and share information</p>
	Philanthropy and Investment	<p>Invests in the local economy in communities where they operate</p> <p>Supports science education in the schools</p> <p>Contributes to community projects, including roads, water treatment, and utilities</p> <p>Gives back to the local community</p>
COMPLIANCE	Environmental Protection	<p>Contributes to projects that help improve the environment</p> <p>Sets aside money to fund environmental clean-up</p> <p>Exceeds government standards for reducing emissions from manufacturing plants</p> <p>Produces products with minimal environmental impact</p>
	Governance and Cooperation	<p>Follows all laws and regulations related to plant safety</p> <p>Cooperates with government regulators</p> <p>Provides accurate and honest information to government authorities, and the Environmental Protection Agency</p> <p>Works with independent advisory panels to establish and enforce best practices</p> <p>Employs honest and ethical senior management</p> <p>Develops and enforces standards that are consistent across the globe</p>
BUSINESS	Financial Strength	<p>Invests in future growth and expansion</p> <p>Has a record of stable financial performance</p>

Source: APCO Worldwide, 2007

Local Communities, Activist Groups, and Public Sector Agencies as Stakeholders

Corporate social responsibility (CSR) is becoming a more and more powerful image tool in building reputation capital. Numerous prizes, including The Conference Board's annual Ron Brown Award, recognize the commitment shown by many enterprises in a variety of social, environmental, and ethical causes. Social responsibility guidelines (such as those proposed for multinationals by the Global Reporting Initiative, published by CERES and the OECD) have been gaining momentum internationally. Some institutional investors, including large public and corporate pension funds, have begun to adopt a wide range of extra-financial (including environmental, social, and governance (ESG)) criteria in selecting their investments.³⁶ Certain regulations, especially in European countries and at the European Union level, require public administrations to favor socially responsible firms in awarding public contracts.³⁷ Finally, in the current business environment, a company that fails to position itself as a responsible corporate citizen may face a serious reputation risk as a result of the scrutiny and criticism of local communities and activist groups.

For these reasons, companies should not miss the opportunity to engage with and build the trust of important categories of stakeholders, including governmental agencies and public-sector contractors.³⁸ However, some commentators and securities analysts have expressed skepticism about the strategic value that a company may reap from some of these initiatives and even questioned, at times, their real social

and ethical impact. As a result, CSR programs adopted by an organization should be based on the maximum degree of integrity and transparency. Since the uncovering of any wrongdoing in this area may disappoint and even estrange stakeholders (including customers), with grave ripple effects on corporate reputation, it is the corporate governance responsibility of the board to oversee the company's CSR policies and their practical implementation by the organization so as to ensure that they are not self-serving or commercially driven.

Specifically, a board should consider:

- Requesting information from management on the company's CSR policies and implementation program as well as management's assessment of the reputation capital that the company aims at gaining through the program;
- Analyzing the stakeholder interests addressed by those policies and determine whether the relationship with such categories of stakeholders contributes to furthering the company's long-term strategic objectives;
- Assessing the public perception of the company's involvement in the social program (media coverage, research analyst reports, rating agency analyses, etc.);
- In those situations where the board is not comfortable with the information received or the analysis conducted, engaging directly with representatives of stakeholders to receive their feedback on the company's support of certain social causes.

³⁶ For an overview, see Gordon Leslie Clark and Tessa Hebb, "Why Do They Care? The Market for Corporate Global Responsibility and the Role of Institutional Investors," Oxford University Center for the Environment Working Paper Series, 2007.

³⁷ Charles J. Fombrun, "Building Corporate Reputation Through CSR Initiatives: Evolving Standards," *Corporate Reputation Review*, Vol. 8, No. 1, 2005, pp. 7-11, citing the 2002 Communication on CSR strategy by the European Commission, the establishment of a European Multi-Stakeholder Forum on these issues, and a law passed by the local government of Umbria, in Italy. Also see Charles J. Fombrun, Naomi A. Garberg, and Michael L. Barnett, "Opportunity Platforms and Safety Nets: Corporate Citizenship and Reputational Risk," *Business and Society Review*, 2000, p. 85.

³⁸ Laura Tucker and T.C. Melewar, "Corporate Reputation and Crisis Management: The Threat and Manageability of Anti-Corporatism," *Corporate Reputation Review*, Vol. 7, No. 4, 2005, pp. 377-387. On the value of CSR policies as a "reservoir of goodwill," see Karen Schnietz and Marc J. Epstein, "Exploring the Financial Value of a Reputation for Corporate Social Responsibility During a Crisis," *Corporate Reputation Review*, Vol. 7, No. 4, 2005, pp. 327-345 (which tests a number of assumptions on companies exposed to the 1999 Seattle WTO crisis).

Cause or Effect?

The Nature of Reputation Risk

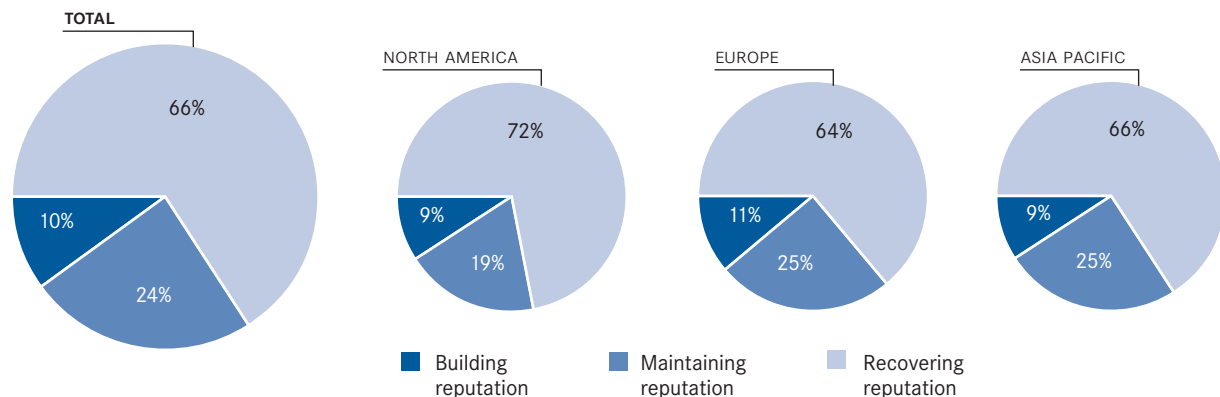
Boards should discuss and understand the nature of reputation risk as an effect of certain business operational incidents, not as a separate and distinct category of uncertainties. Accordingly, directors should consider objecting to the establishment of a dedicated organizational platform to address reputation risk, as it would conflict with current risk management integration best practices and retard the development of a full-fledged enterprise risk management (ERM) program. Failing to embed reputation risk into ERM could lead to inefficiencies and disparities in the company’s response to risk events; in addition, it could undermine the firm’s ability to foster a cohesive culture of risk awareness.

As discussed, business reputation grows and strengthens only over time, as a reflection of the company’s relations with key stakeholders. However, in a highly interactive and technological world where news disseminates instantaneously with just a few clicks of a mouse, events shedding a negative light on a company

can jeopardize and even destroy its standing overnight. Once reputation is compromised, the process of rebuilding it may be costly and extremely lengthy; in worst-case situations, reputation capital may never be recovered (see Figure 2).

Figure 2

What is the most challenging stage of reputation management?



Source: *Safeguarding Reputation*, Weber Shandwick, Issue No. 1, 2007, p. 3. Data are based on a survey of 950 business executives conducted in collaboration with KRC Research.

Reputation oversight should therefore reach beyond what management does to enhance the perception of the firm and create reputation wealth. Given the risks that such an intangible asset is exposed to, boards of directors should also consider performing a corporate reputation risk management oversight function.

A Definition of Reputation Risk

A “reputation risk” materializes when the negative publicity triggered by certain business events, whether accurate or not, compromises the company’s reputation capital and results in value loss for the firm. For example, in the Martha Stewart Living Omnimedia (MSLO) case, the company was exposed to the strategic risk of excessive dependence on and identification with its founder. When Ms. Stewart was implicated in a long and highly publicized investigation regarding her personal conduct outside of her business functions, the dependence of the company’s reputation on and its identification with Ms. Stewart seriously penalized the firm’s crucial relations with advertisers and, eventually, its stock performance.³⁹

Like other types of risk, reputation risk has a factual premise (i.e., the triggering business event), manifests itself through a series of other factual circumstances (i.e., the negative publicity), and ends in a consequence (i.e., the value loss).

Unlike the MSLO case, *triggering events* usually occur within the firm (and relate to organizational practices or conduct – which may be illegal, unethical, or simply questionable under prevailing standards or value sets – that were previously unknown to the public) or affect the quality or safety of business products and services.

Negative publicity may occur through (discovery and) public revelation of the triggering event by an insider (sometimes accidentally), a whistle-blowing employee, a zealous reporter, a court decision, or a stakeholder who has been directly affected by the event (e.g., the consumer of a defective product). It is not uncommon for negative publicity to be magnified or exaggerated: for example, at times, negative publicity may result from a campaign mounted by a disgruntled group of stakeholders to discredit the company (i.e., the protest of an activist group) or to induce it to revisit the terms of its stakeholder relationship (i.e., a workforce strike).

Finally, *value loss* is the reputation capital reduction measurable on aspects of those stakeholder relations that are instrumental to the pursuit of the firm’s long-term growth and shareholder value (i.e., firm revenues, market share, brand recognition, ability to recruit and retain talent, supply arrangements, reputation rankings, and other enterprise valuables, or any combination of the aforementioned).

What distinguishes reputation risk from other types of risk is that the triggering event also constitutes another business risk, with its own factual circumstances and consequences for the company. In the case of Martha Stewart Living Omnimedia, that risk was strategic; more often than not, however, it is operational. For example, BP, the British oil giant, suffered a recent reputation failure as a result of a string of grave accidents at U.S. facilities and the subsequent revelations of negligent safety and security. In spite of their reputational consequences, the accidents were – first and foremost – serious operational risks.⁴⁰ Due to this “compounded” nature, reputation risk has been qualified as a “risk of risks.”⁴¹

³⁹ See Appendix I (“Case Studies,”) on p. 43. On the strategic risk posed by executive reputation, see Jennifer Francis, Allen H. Huang, Shiva Rajgopal, and Amy Y. Zang, “CEO Reputation and Earnings Quality,” Fuqua School of Business Working Paper, October 2004. On the reputational impact of strategic risks, see “The Impact of Corporate Strategy on a Firm’s Reputation,” *Corporate Reputation Review*, Vol. 8, No. 3, 2005, p. 187.

⁴⁰ See Appendix I (“Case Studies,”) on p. 43.

⁴¹ See *Reputation: Risk of Risks*, Economist Intelligence Unit, December 2005.

Reputation as a Risk Effect

Literature on reputation risk management has been proliferating in recent years, addressing issues such as how a company can anticipate major triggering events; what techniques should be used to assess their likelihood (i.e., the probability that the triggering event breaks the news) and impact (i.e., the degree of negative publicity); and what strategies should be implemented to mitigate their effects (especially when the extent of the value loss is such as to compromise the company's ability to pursue its long-term objectives).

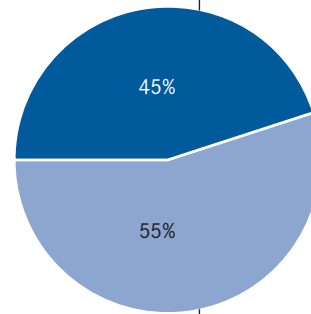
The resolution of these issues depends on a fundamental preliminary question on which experts are divided, that is whether corporate reputation should be treated by risk managers as a separate and autonomous type of business risk or – due to its causative relationship with operational risk – as one of the effects of operational incidents. Corporate boards would certainly benefit from some guidance on this point, as the latest statistics indicate. According to the Audit Committee 2007 Member Survey conducted by KPMG's Audit Committee Institute jointly with the National Association of Corporate Directors, 55 percent of respondents believe that reputation risk should be managed and overseen not as a separate and discrete risk to the company but as a consequence of the failure to manage other risks effectively (see Figure 3).⁴²

The answer to what may seem a merely conceptual question has, in fact, a number of implications on the design and execution of risk management programs. For example, those who believe that reputation should be managed separately emphasize the correlation between reputation and communication and support the need to centralize a multidisciplinary set of knowledge (market research, human resource management, investor relations, etc.) around an office with the authority and stature to communicate promptly and effectively with the public on behalf of the company. Therefore, they recommend designating a dedicated reputation risk owner at the entity level, possibly with C-suite status.⁴³ According to this view, a chief repu-

Figure 3

Should reputation risk be managed and overseen as a separate and discrete risk to the company?

Yes, reputation risk should be managed and overseen as a separate and discrete risk to the company



No, reputation risk should be managed and overseen as a consequence of the failure to manage other risks effectively

Source: KPMG Audit Committee Institute/National Association of Corporate Directors, 2007.

tation officer should be responsible to coordinate for the whole organization such traditional risk management activities as the identification, assessment, and response to any event triggering a material reputation failure.

A second school of thought warns about the difficulty of separating effects on reputation capital from their operational causes and criticizes this “one-stop solution” to reputation risk for conflicting with the integration process that risk management has been undergoing in the last few years. Risk management

⁴² 2nd Annual ACI/NACD Public Company Audit Committee Member Survey, KPMG's Audit Committee Institute/National Association of Corporate Directors, 2006-2007.

⁴³ Charles J. Fombrun, *Reputation: Realizing Value from the Corporate Image*, Harvard Business School Press, 1996, p. 441; Ronald J. Alsop, “Reputation Officers: A New Breed of Executive,” *Wall Street Journal*, April 14, 2004; and Ronald J. Alsop, *The 18 Immutable Laws of Corporate Reputation: Creating, Protecting and Repairing Your Most Valuable Assets*, Wall Street Journal Press, 2004; and Ronald J. Alsop, “Reputation Officers: A New Breed of Executives,” *Wall Street Journal* (careerjournal.com), April 13, 2004. For a recent critique of what appears as a merely reactive, damage-control initiative, see “Chief Receptionist Officer? Title Inflation Hits the C-Suite,” *Knowledge@Wharton*, May 30, 2007.

has long been bound by a tradition of segmentation, which has caused economic and organizational inefficiencies and limited the effectiveness of a company's response to uncertainties. According to this second theory, establishing a special and distinct risk management platform to exclusively address issues of reputation could favor further fragmentation and impede progress towards a full-fledged enterprise risk management program.⁴⁴

In particular, solutions could be duplicated, with disjointed response strategies to different effects of the same event. The danger is that, instead of focusing on the remedy to the event, a firm could limit its action to controlling or mitigating the event's consequences. For example, in the case of a company that suffered an environmental accident, reassuring the public about the safety of a production plant by launching an intensive communication campaign on the company's commitment to social responsibility could be confused for the solution to the obsolescence of business equipment. In the long term, this approach would inevitably be disastrous for the organization. Eventually, duplication could also undermine the development of a cohesive culture of risk awareness, which is one of the most difficult challenges faced today by risk executives in their organizations.

Washington Summit delegates discussed at length these opposing views and tended to favor the classification of reputation risk as an effect of other business events. Reputation failures stem from operational incidents and require an attentive communication response. However, a company should not make the mistake of fragmenting the responsibility for the underlying risk between the operational risk owner and a dedicated office in charge of reputation, as that would undermine the system of accountability on which business unit managers and other risk owners operate. In fact, a business unit manager who knows that an operational incident is being measured by Reputation Quotients and corrected through a communication strategy has less incentive to invest in preventing a new occurrence and can simply hide behind the widening gap between corporate identity and reputation.

In conclusion, instead of extrapolating reputation from the existing risk management structure, a corporation should pursue the full integration of communication tactics and public relation practices into a cohesive and unitary response strategy that aims at correcting the causative business incident. For this purpose, corporate boards should ensure that the organization avails itself of a comprehensive, top-down, and holistic risk management program aligned with current best practices.

⁴⁴ Michael Power, *The Risk Management of Everything, Rethinking the Politics of Uncertainty*, Demos, 2004; *Enterprise Risk Management: An Emerging Model for Building Shareholder Value*, KPMG's Audit Committee Institute, September 2003.

Reputation Risk and Enterprise Risk Management

Directors should oversee the design and implementation of a strategic, top-down, and holistic risk management program where all business events with potential consequences to the firm's reputation capital are identified, measured vis-à-vis tolerance levels and appetite for risk, and addressed in a timely manner. Enterprise risk management enables the company to elevate relevant reputation issues to the board level, where they can be analyzed strategically for their potential impact on long-term shareholder value.

Business organizations have historically put in place some form of risk management processes to protect their assets and insure their activities against uncertainties. In the past, these solutions were often fragmented, left to the sensitivity of senior managers or the initiative of single business unit risk owners, and unrelated to a comprehensive vision of the enterprise's long-term goals. In addition, due to the limited budgetary resources traditionally devoted to risk management programs (and often available only to internal audit and insurance departments), those efforts did not go beyond protecting the company from the most significant, insurable risks.

Experts have long advocated the need to integrate risk management activities. Enterprise risk management – or ERM – was formulated by the Committee of Sponsoring Organizations of the Treadway Commission (COSO) and other self-regulatory bodies as an actionable tool to depart from the traditional, segmented approach to risk management and foster a strategic, top-down, and holistic view of business risk.⁴⁵ The risk of reputation failures (intended as the effects of operational incidents on reputation capital) should not be left out of this picture; in fact, it should take center stage in the risk management integration effort.

Delegates to the March 2007 Corporate/Investor Summit discussed the main features of an ERM program in the context of reputation risk management.

Reputation Risk as a Strategic Opportunity

First of all, ERM is a tool to elevate risk management to a strategic level. There are two facets of any risk management activity: a preventive, control-based aspect and a forward-looking and entrepreneurial aspect. Traditional risk management solutions tend to focus on negative events and often depend on diligent corporate compliance programs to control their occurrence. ERM, instead, relies on an infrastructure designed to elevate material risk issues to the senior management and board levels; such a structure can help the corporation find a better balance between loss-prevention, risk mitigation efforts, and entrepreneurial, risk-taking endeavors.

In particular, ERM may be used by the organization to fully uncover the value associated with intangible assets and discuss their efficient deployment in the business strategy. Companies used to derive most of

⁴⁵ Committee of Sponsoring Organizations of the Treadway Commission (COSO), *Enterprise Risk Management-Integrated Framework*, September 2004. This framework was created to be a benchmarking tool for an organization to assess currently adopted risk management solutions and draw a road map toward full ERM implementation. Other ERM frameworks include: the *Australian/New Zealand Standard for Risk Management 4360*, 1999; the model embedded in the *King Report on Corporate Governance for South Africa*, 2002; British business standard BB 6079-3 (*Project Management: Guide to the Management of Business Related Project Risk*, 2000); and *ISO/IEC Guide 73 (Risk Management: Vocabulary – Guidelines for Use in Standards*, 2005). Also see Matteo Tonello, *Emerging Governance Practices in Enterprise Risk Management*, The Conference Board Research Report, R-1898-07-WG, 2007, p. 12.

their firms' value from tangible assets like plants and equipment; in a modern, knowledge-based economy, however, the sources for corporate profits are more likely to be found in a variety of intangible assets.⁴⁶ Product brands, marketing processes, and – most important – the nexus of key stakeholder relationships that constitute reputation capital belong to this asset category.

In order to protect and enhance their reputation capital, organizations must be able to rely on an enterprise-wide process that:

- Maintains an asset inventory where the relationships constituting reputation capital are classified according to: their nature (i.e., enabling, customer, normative, peer, and special interest relations); the criticality, rationality, and urgency of stakeholders' claims; their influence on and control of key business resources; and their proneness to support corporate deliberations.⁴⁷
- Quantifies their intrinsic value, determines their propensity to be strategically deployed, assesses their impact on risk appetite (i.e., how much risk the business is capable of undertaking in the pursuit of its strategic vision), and evaluates their actual contribution to long-term business growth.⁴⁸
- Develops a set of extra-financial measures of performance appropriate to assess whether reputation-capital stakeholder relations are

being adequately developed and deployed in the pursuit of the business strategy.

- Clearly communicates such information to the market.

If adequately implemented, an enterprise-wide process of this sort ensures that business potentials of material stakeholder relations are unlocked and the company is set to meet its long-term objectives.

The View of Reputation from the Top

Traditionally, corporations have left it to the discretion of single business units to assess the relevance of a risk issue and decide if it requires an immediate mitigation response and should be raised to higher ranks in the chain of command or if it should simply be disregarded as immaterial.

With ERM, this approach is inverted and managing risk becomes a cohesive ongoing activity. This activity is procedural, designed by senior management, and overseen by the corporate board. Integrated risk management procedures rely on a set of standards applicable enterprise-wide, including tolerance units (i.e., the acceptable level of variation relative to the achievement of a specific business objective, as measured at a business unit level) and the firm's overall risk appetite (i.e., the broad-based, high-level view of how much risk the company is capable of undertaking in pursuit of its strategic vision).⁴⁹ While the bottom-up risk management solution is a reactive, ad hoc response to negative events, a top-down ERM framework is designed to be an anticipatory procedural tool to ensure that risk is fully understood even before its occurrence.

In ERM, the corporate board provides the impetus for any needed organizational change, oversees the coherence of the program designed and implemented by senior management throughout the enterprise, and ensures that the corporate culture supporting the integration effort is aligned with the firm's long-term

⁴⁶ For recent data on the impact of intangible assets on certain countries' economies, see *Data for Intangibles in Selected OECD Countries*, OECD and Statistics Netherlands, 2005, available at www.oecd.org. Intangibles can be categorized as intellectual capital (i.e., copy-rightable work products) and relational capital (i.e. reputation capital). On reputation capital as a source of corporate value, see Grahame R. Dowling, "How Good Corporate Reputations Create Corporate Value," *Corporate Reputation Review*, Vol. 9, No. 2, 2006, pp. 134-143.

⁴⁷ See p. 13 for the discussion of these circumstantial evaluation criteria.

⁴⁸ On the accountancy approach to risk management, where reputation is quantified and accounted for as a strategic asset subject to business uncertainties, see J. Rayner, *Managing Reputation Risk*, Wiley and Institute of Internal Auditors, UK and Ireland, 2003; and J. Larkin, *Strategic Reputation Risk Management*, Palgrave/Macmillan, New York, 2003.

⁴⁹ Tonello, *Emerging Governance Practices*, p. 71.

strategic objectives. Although the responsibility for the implementation of risk management processes remains with senior managers, the corporate board is the main sponsor and supporter of the ERM effort as well as, in its oversight capacity, the final recipient of the knowledge on risk that ERM brings to the organization. The whole ERM infrastructure should be designed so as to facilitate such a flow of information from and to the top level.

Embedding the risks facing reputation capital into this process allows the board to monitor this corporate asset, understand how business ramifications affect it, and make informed decisions on its protection and enhancement.

Capturing Reputation Risk Across the Enterprise

As discussed, the impact of certain business risks on reputation capital may be catastrophic and a risk of its own that is often the least assessable and insurable of all. Examples already mentioned include the recall of a defective or dangerous product, a sudden need to close a production facility due to force majeure or environmental issues, or the public revelation of ethical standard violations.

Due to this “compounded” nature of reputation risk as a risk of risks, organizations need more than a chief reputation office to coordinate external affairs, communication, and public relations. What is necessary is a set of processes to encompass the wide array of business risks the corporation is exposed to (including strategic and operational risks) and to fully comprehend how they affect the firm’s public perception. These processes should aim at controlling any potential damage to the corporate image not only by means of a communication strategy but also through a satisfactory response to any business risk originating from the reputation failure.

By assigning the responsibility to protect reputation to a dedicated office staffed with communication and marketing specialists, the company would only capture a single aspect of the reputation issue and possibly alienate other risk managers. To gain a portfolio view of business risk and its implications, a company should instead rely on a comprehensive ERM program that is integral to running a business and has cross-functional ramifications across the enterprise. ERM fosters consistency in a company’s response to the downside of risk and ensures that its long-term strategic potential (i.e., those stakeholder relations that are instrumental to the firm’s objectives and can be further enhanced) is captured, raised to higher corporate ranks, and, if material, considered at the board level.

As a result of this complex but coordinated effort, the whole organization’s sensitivity to uncertainties should be raised. With time, each employee should acquire the necessary sensitivity and discipline to recognize material reputation issues, attributes that are required for a new corporate culture geared towards full protection of reputation capital and other invisible, intangible assets. Specifically, in a full-fledged ERM environment, each employee should feel free to express risk-related concerns without fear of retribution.

The Role of the Board

A Road Map to Integrated Reputation Risk Governance

Boards of directors should consider adhering to The Conference Board Road Map to Risk Governance to embed reputation risk oversight into a comprehensive risk management program. Specifically, the board should ensure that such ERM phases as the risk portfolio compilation, assessment, and response strategy determination do not disregard potential effects of business risk events on reputation capital.

In the fall of 2006, The Conference Board Research Working Group on Enterprise Risk Management was instituted to identify best practices for corporate boards engaged in overseeing ERM's design and implementation. The Group's final report, *Emerging Governance Practices in Enterprise Risk Management* (February 2007), outlines the fundamental components of the ERM program infrastructure and draws a risk governance road map for boards of directors.⁵⁰

This section builds upon those research findings and the March 2007 Corporate/Investor Summit discussion on the role of the board in enhancing and protecting the firm's reputation. The purpose of the section is to illustrate a number of practical steps for corporate boards undertaking to embed reputation risk oversight into a comprehensive risk management process. Since it describes the process in full and defines the nomen-

clature used throughout this section, *Emerging Governance Practices in Enterprise Risk Management* should serve as a complement to these pages.

Directors should be mindful of reputation risk through each of the following stages in the development and execution of the ERM program:

1. **Appreciate the importance of ERM as a reputation risk management tool** Board members need to become knowledgeable about ERM and appreciate its value as an instrument to anticipate and address the consequences of business risks on corporate reputation. For this purpose, directors should request adequate informational materials from management and, if necessary, should retain advice from independent external experts (including communication specialists).
2. **Assess gaps and vulnerability in existing reputation risk management solutions** The corporate board should be persuaded by the business case for implementing ERM. The decision to invest in an ERM program should be based on a detailed analysis of the limitations inherent in risk management solutions already adopted by the company. Specifically, directors should convene that the holistic nature of ERM makes it the ideal tool to develop a cohesive, firm-specific definition of reputation capital based on the assessment of all key stakeholder relations.

⁵⁰ Matteo Tonello, *Emerging Governance Practices in Enterprise Risk Management*, p. 30 ("The ERM Infrastructure"), p. 43 ("ERM at Work,") and p. 92 ("The ERM Road Map"). Opinion-based research conducted in 2006 by The Conference Board revealed a false sense of security among U.S. corporate directors, the majority of whom stated that they felt comfortable about the way their companies are managing risk (whereas, in fact, only a few respondents could point to the use of a robust and integrated risk management program); see Brancato, et al., *The Role of U.S. Corporate Boards in Enterprise Risk Management*, p. 13. For additional survey findings on ERM by The Conference Board, see Stephen Gates and Ellen Hexter, *From Risk Management to Risk Strategy*, The Conference Board Research Report, R-1363-05-RR, 2005; and Ellen Hexter, *Risky Business: Is Enterprise Risk Management Losing Ground?* The Conference Board Research Report, R-1407-07-RR, 2007.

3. **Set an underlying mission and discuss reputation enhancement as a program objective** The ERM business case should be formulated as a concise and effective mission statement, which is articulated in the main program objectives and tied to the firm's strategic goals. Protecting and enhancing corporate reputation should be one of these goals.
4. **Establish the ERM infrastructure and assign leadership without duplicating roles** As part of this step, dedicated board members and senior executives should discuss corporate risk governance policies, draft (or revise) charters or other organizational documents to incorporate ERM functions, and assign the program leadership at the executive level. As discussed, the board should consider objecting to the assignment of responsibilities for corporate reputation protection to a separate and distinct risk leader; on the contrary, directors should ensure that the firm's charters and executive employment agreements explicitly refer to the role of each organizational component of the ERM infrastructure in identifying, assessing, and addressing the consequences of business risks on corporate reputation.
5. **Compile a risk inventory that also illustrates potential reputation effects** Risks facing the business should be identified, categorized, and prioritized, even with respect to the likelihood and extent of their effects on reputation capital. Since the accuracy of the risk portfolio is a precondition to the success of the whole program, the board should oversee the process to take inventory of risk and become comfortable about its effectiveness and thoroughness. In order to avoid redundancies and confusion, the possibility of reputation failure should be analyzed and highlighted for each business and operational risk category but should not constitute a separate category in the risk portfolio.
6. **Select assessment techniques and define risk appetite and tolerance** The selection of appropriate risk measurements should be made based on the nature of each risk in the portfolio, the amount and depth of data required to apply the measure being considered, and the organizational capacity of the business unit in charge of responding to the risk event. Likely consequences on reputation capital should also be assessed, based on the evaluation of:
 - Each business risk's actual influence on a key stakeholder relation. For example, the value quantification of business resources (i.e., skilled engineers and other talented employees) that the company will no longer be able to access or retain as a result of a compromised stakeholder relation (i.e., failure to concede to salary increase demands by trade unions).
 - The criticality to the company's long-term objectives of the specific relation being affected by the business risk (i.e., the cost of procuring those resources elsewhere; for example, through outsourcing arrangements with a foreign company).
 - The widening gap (and potential ripple effects of the gap) between corporate identity and corporate reputation. For example, the difficulty of obtaining favorable outsourcing contract terms if activist groups speculate on the trade union incident and mount a negative publicity campaign against the company by raising doubts about its ethical behavior in emerging labor markets.
7. **Determine response strategies to risk events and reputation effects** Risk owners are accountable for the response to events assigned to their area of responsibility. Nonetheless, because of the comprehensive and cohesive nature of the ERM program, their response should no longer be disjointed from other divisions of the firm and should be taken according to a set of response criteria and guidelines (the "response strategy") predetermined as part of designed procedures. A response strategy should be developed for each risk category in the portfolio and take into consideration effects on reputation. Communication tactics should corroborate a risk response strategy and not be the only response to an operational incident.

- 8. Develop effective internal communication and reporting protocols** An internal flow of information is essential to the success of ERM. Therefore, in designing the program, senior management should pay extra attention to establishing coherent communication and reporting practices. Board members, for their part, should analyze the quality of internal reporting lines and be confident, among other things, that information on corporate reputation with financial value and material for strategic purposes will be channeled upstream and brought to their attention.
- 9. Monitor ERM implementation and execution** In an integrated risk management environment, any activity conducted to identify, assess, and respond to risk should be monitored on an ongoing basis. Monitoring functions are embedded in the program and assigned to any organizational level so that they can be performed in the ordinary course of running a business. Large companies should avail themselves of dedicated evaluation teams and sophisticated flowcharts and diagrams to ensure the enterprise-wide ramification of the monitoring function. Communication experts, investor relation officers, and members of the staff for the preparation of public disclosure documents should be invited to participate in the monitoring and evaluation team. Monitoring reports should explicitly assess the quality of the ERM program as a reputation risk management tool.
- 10. Choose compensation policies and performance metrics to promote and track the pursuit of long-term reputation capital** The board should never let executive compensation issues influence the risk measure selection process. Although companies may decide to use qualitative and quantitative risk data as key performance indicators (KPIs) to encourage the enhancement of their business risk management program, corporate boards should ensure that KPIs are chosen only after completing the ERM process design. Specifically with respect to corporate reputation, if KPIs were chosen before developing ERM, management would be put in a position where it could sabotage the ERM design so that certain reputation failures do not compromise its ability to maximize personal compensation.

- 11. Integrate ERM with existing operational systems** Reputation is a risk of risks and can be damaged as a result of the occurrence of events companies have long been equipped to face. As embedded in ERM, reputation risk management should leverage existing operational platforms, including the company's compliance program and internal control processes (i.e., ethics and compliance program, internal control and disclosure procedures, quality control and Six Sigma processes, accounting/budgeting/planning, etc.). Delegates to the March 2007 Corporate/Investor Summit confirmed The Conference Board's 2006 Research Working Group findings, which states that fully integrating ERM with such existing procedural systems represents the most advanced (and least implemented) stages in an ERM program.

Risk Governance vs. Bottom-Up Risk Management

Practically every organization somehow deals with risks on a day-to-day basis. However, The Conference Board's 2006 Research Working Group found that the bottom-up approach to risk management remains the most common. A bottom-up approach means that it is left to the single business unit to decide whether a risk issue is material and should be raised to the consideration of higher ranks in the corporate structure.

The bottom-up approach to risk management creates a whole series of problems. Here are a few of them:

- Segmentation, which means that risk owners at the business unit level tend to operate in silos, with little communication with other business units and other levels of the organization, except for the level immediately above them, which they report to.
- Inefficient use of corporate resources, as a result of the segmentation and the suboptimal exploitation of internal synergies.
- Inconsistency of risk responses, which lack a common strategy and are left to the initiative, expertise, and sensitivity of key individuals.

- Succession problems, given that – in the absence of a coherent program to address transition phases – when and if key individuals with risk management responsibilities leave or retire from the company, the organization also loses its main resource in the field (that is, the individuals' knowledge).

With ERM, the approach to risk management is inverted and becomes top-down, with a fundamental role assigned to the corporate board. The board is not necessarily the originator of the ERM initiative. Regardless of who initiates the effort, the board should a) comprehend its philosophy, understand how it works, and remain abreast of evolving practices in the field; b) become persuaded about its strategic value; and c) endorse it and fully support it.

How to Make It Practical

Boards are overwhelmed with responsibilities these days. How can they make their risk oversight role practical and fulfill it efficiently? Should it be a function of the full board or should it be assigned to one or more committees? What criteria should be used to assign risk oversight responsibility to one or more leaders within the board? The Conference Board Research Working Group on ERM made the following recommendations.

Conduct a Preliminary Analysis of Corporate Governance Practices, which means considering qualities such as the independence, professional expertise, and time availability of board members. Since a successful ERM program depends on the ability to reform corporate culture, it is important that the organization believes in the integrity and moral authority of their ERM leaders (at the board and executive levels).

Consider Establishing a Dedicated Risk Committee

According to The Conference Board's 2006 director survey, 66 percent of companies still assign risk oversight to their audit committee. However, a growing number of companies (23 percent to 28 percent) have recognized how overburdened audit committees are (especially with their internal control and Sarbanes-Oxley Section 404 oversight responsibilities) and have shifted some risk oversight responsibilities to either a combination of the audit committee and another committee (such as the governance committee, as in the case of MetLife) or to a dedicated risk committee.

Companies that have established risk committees are clustered in the financial sector: Wachovia, Citigroup, and JPMorgan Chase are some examples. What is certain is that – due to the need to work closely with management on ERM – the risk oversight role of the board would be performed more effectively and expeditiously if delegated to a committee. Plus, if a group of directors is dedicated to overseeing risk, they will develop a real expertise over time and make a valuable contribution to the program. Nevertheless, the full board remains the ultimate recipient of the knowledge of risk acquired by the organization through the ERM program and should use such knowledge for the purpose of setting a risk-adjusted corporate strategy.

Source: Tonello, *Emerging Corporate Governance Practices*, p. 30; Brancato, et al., *The Role of U.S. Corporate Boards*, p. 26.

Reputation Measures as Criteria for Risk Portfolio Compilation

The board of directors should oversee the process adopted by senior executives to identify, categorize, and prioritize business uncertainties, even with respect to their reputation effects. Directors should ensure that prioritization criteria and other techniques used in compiling a risk portfolio comprise, among others, a set of reputation metrics. Specifically, the inclusion of a risk event in the portfolio should be based on the likelihood and impact of the event's consequences on the company's reputation capital.

Notable business cases show that reputation effects of certain operational events can compound and negatively impact cost of capital and share price.⁵¹ Leading boards of directors are therefore starting to become aware that reputation connotes a measurable business risk and are thinking proactively as to how their organizations can be positioned to identify and anticipate major uncertainties in this arena.

From a corporate governance standpoint, the role of directors in phases such as the risk portfolio compilation cannot be overstated. Board members not only contribute their knowledge and expertise but also oversee the process adopted by senior managers to identify and prioritize risks. This is especially important, since, if material risks are (accidentally or deliberately) excluded from the analysis, then the rest of the ERM program will suffer a major deficiency.

As they approach ERM from a governance perspective, board members should remain aware that certain business risks may represent personal opportunities for dishonest, ill-intentioned managers. In those cases, managers may bear an interest in avoiding having those categories of potential events brought to the surface and addressed in a systematic and effective way, in spite of the potentially disastrous consequences that the company's reputation could suffer from those occurrences.

For example, delegates to the March 2007 Corporate/Investor Summit discussed the situation where a company risked a grave reputation capital loss due to the failure by a business unit manager to report new data on the environmental hazard of a local production process. In this case, the underlying operational risk was identified at the business unit level but not elevated to the entity level through the official identification process because the linkage between the compensation of senior business unit managers and local production output functioned as a disincentive. To avoid similar pitfalls, the board should consider becoming familiar with the risk event identification techniques chosen by senior executives (e.g., interviews, questionnaires and surveys, focus groups and facilitated workshops, market analyses, industry benchmarks, geopolitical reports, media clipping services, etc.), understand their limitations, and be able to critically analyze their outcomes in light of circumstances facing the company or its divisions.

Board members should also be sensitive to the fact that reputation failures can be the result of interrelated business events. In the case just discussed, an operational shortcoming has serious reputation effects if it is not addressed promptly due to the negligent, unethical behavior of a business manager. In other words, the major damage to reputation capital is not determined by the environmental hazard alone (operational risk) but also by the perception that management does not meet public expectations in terms of ethical standards (risk of fraud), the board's oversight is ineffective

⁵¹ See Appendix I ("Case Studies,") on p. 43.

(governance risk), or the company does not avail itself of a thorough compliance program (compliance risk). In those situations, identification techniques should be sophisticated enough to break down and assess the single subcomponents of the causative relationship.

For the same reason, directors should consider encouraging senior managers to include among identification, categorization, and prioritization criteria a set of reputation metrics so that business risks are fully evaluated even with respect to the likelihood and significance of their reputation effects. Therefore, senior executives of a multinational corporation with production activities fragmented among several foreign countries should not limit their evaluation of a business risk category to its operational effects. Instead, by expanding their analysis to reputation implications, those executives may conclude that, for example, the risk of having to recall defective products manufactured by a single production unit should receive high priority in the risk portfolio even if the immediate operational impact of

its occurrence (i.e., a reduced product inventory in a single geographic region) is not material because it remains within pre-determined tolerance levels.

The event identification process is crucial to ERM as it represents the opportunity for the company to expand and classify its knowledge of business risks. As discussed, boards should understand the process' rationale and avoid inefficient category duplications, which could generate confusion, determine situations of unaccountability, and ultimately undermine the effectiveness of the program. It is in this context that directors should use the dataset of key stakeholder relations that, as discussed earlier,⁵² the board has been developing as part of its reputation capital analysis. The efficiency of the program is guaranteed if the board and senior executives bring to the risk identification process their understanding of the elements that

⁵² See "A Stakeholder Base Analysis of Corporate Reputation," on p. 13.

Table 3

Examples of Business Risks Affecting Reputation Capital

<i>Business Risk</i>	<i>Affected Stakeholder Relations</i>
Strategic Risks	
Lack of coherent business strategy; Sudden strategic change; Strategy implementation failure	Shareholders and other investors
Operational Risks	
Financial performance	Shareholders and other investors
Product/service quality	Customers
Production failure/Insufficient capacity	Customers
Trademark/Brand erosion	Customers; Suppliers
Scalability obstacle	Suppliers; Partners (insufficient scalability may reduce the ability to establish relations with high-profile partners or suppliers)
Human resources	Employees
Health & safety	Customers; Local communities
Governance risk (incl. ethics/compliance/environmental)	Government; Shareholders; Activist groups

make up reputation capital. In fact, business risks posing a threat merely to residual reputation will be filtered and unnecessary resource expenditures avoided.

In order to ensure that risks facing reputation capital are not grouped into a redundant category but are identified and addressed as specific effects of other business incidents, companies should consider using graphical tools – such as a risk identification matrix – and cross-reference triggering events and the variety of their potential consequences. Corporate/Investor Summit delegates brought up the example of companies using a three-dimensional, cubic matrix – where risk events are organized along the Y-axis, categorizations are illustrated along the X-axis, and effects are shown on the Z-axis. As they figuratively link reputation effects to their triggering events, these tools can help illustrate the causative relationship between business risks and reputation capital damage.

The Reputation Effects of Governance Risk

As part of its oversight of the risk identification process, the board should verify that the process is suited to fully examine and categorize possible shortcomings in the areas of governance, ethics, compliance, and corporate responsibility. There are a number of events in these areas that could undermine the integrity of the corporate culture and have disastrous implications on business image and reputation capital. They should be accurately described and grouped into a separate category (the “governance risk” category) in the company’s risk portfolio. Examples include:

- Harassment or discriminatory behaviors within the organization;
- Retaliation against whistle-blowers;
- Engaging in bribery or other forms of corruption of public officials of foreign countries to facilitate the achievement of business goals;
- Engaging in political lobbying activities in disregard of applicable standards and regulations;
- Practicing unfair competition;
- Adopting financial engineering schemes to fictitiously increase revenue lines or reduce expenses;
- Violating labor and human rights through practices – such as the employment of underage workers – that may not be prosecuted in foreign markets but would be unlawful in the United States or under international law;
- Infringing copyrights, data security standards, or privacy laws; and
- Deliberately engaging in business activities that formally meet environmental legal standards but might constitute a danger to the health and safety of employees, customers, or local communities.⁵³

⁵³ Research shows that the reputational impact of governance risk on stock price is over twice as large as the impact of other operational incidents: see Jason Perry and Patrick de Fontnouvelle, “Managing Reputational Risk: The Market Reaction to Operational Loss Announcements,” Federal Reserve of Boston Working Paper, October 2005, available at www.ssrn.com. Also see Matteo Tonello, “Risk Governance and Governance Risk: The Role of Directors,” *Directorship Magazine*, October 2007.

Responding to Reputation Threats and Crises

The board should oversee the determination of a proper response strategy to each risk category affecting corporate reputation. Response strategies should be chosen, among other things, on the basis of a resource cost-benefit analysis. Directors should be skeptical of attempts at restoring stakeholder confidence solely through savvy communication tactics, and request that response strategies fully address underlying operational risks. In a well-designed ERM program, communication tactics and better disclosure should be seen as tools to corroborate and complete a business risk response strategy, not to replace it.

Risk owners implement the response to risk events assigned to their area of responsibility. However, in a truly integrated risk management environment, risk owners' responses should no longer be disjointed from other divisions of the firm. Among other things, this ERM feature is crucial to address events threatening reputation capital, given that such events could manifest only at certain levels of the organization and remain unknown by others. For example, in the BP case, it was shown that senior executives in London only had a marginal knowledge of operational issues facing business units overseas, including the degree of deterioration of the group's facilities in Texas and Alaska. Instead of being uncoordinated, responses to risk events should be taken according to a set of response criteria and guidelines (the "response strategy") predetermined as part of procedures designed at the entity level and under the supervision of top management and the board.

A response strategy may consist in avoiding, mitigating, or embracing the effects of a risk event, including its effects on corporate reputation. For example, as discussed by delegates to the March 2007 Corporate/Investor Summit:

- A company concerned about the reputation consequences of ethics and regulatory compliance risks arising from international operations and outsourcing practices (i.e., the risk that a subcontractor employs underage workers and violates human right

conventions, as in the Nike case)⁵⁴ could set a drastic risk avoidance strategy by discontinuing any outsourcing relation in countries with low-cost labor.

- In the MSLO case, the company's response strategy to the business risk posed by Martha Stewart's celebrity status could only be that of mitigation. Even though untimely, the company took a number of actions (e.g., the development of team-based contents for its publishing business segment) to reduce its dependence on the founder.
- Since the 1980s, Benetton Group used a series of aggressive and provocative advertising campaigns, which, in a few years, made its clothing brand recognizable worldwide. The group embraced a significant reputation risk (i.e., the backlash of an ill-suited promotional message) based on the calculated consideration that the benefits that its product brand could derive from such a risk undertaking strategy would outweigh its negative effects on corporate reputation. In assessing reputation capital, Benetton concluded that its relation with a young generation of liberal customers should be given more importance than the relation with special interest groups.

⁵⁴ See Appendix I ("Case Studies,"), on p. 43.

The choice of the most appropriate strategy to respond to a risk category should be supported by a cost-benefit analysis, which includes:

A discussion of the time horizons regarding both the impact of the risk event on reputation capital and the implementation of the risk response.

Conventional wisdom suggests that, in the current business world, damages to reputation can result overnight. The reality is often more complex, and serious damages are measurable only over time (i.e., in the BP case, the damage resulted not merely from a single accident – experienced, in their history, by other oil companies – but also from the investigation that followed, which uncovered a series of negligent behaviors and the lack of an organizational structure to monitor adherence by business divisions to rigorous operational standards). In practice, in order for the company to develop a truly anticipatory response strategy, it may be helpful to recur to simulation exercises to clarify the timeframe in which the effects of a negative event may unfold.⁵⁵

An assessment of the resources the firm would need to deploy to implement a specific response, including the ability to access external capital to finance the response.

As discussed earlier, companies do not have unlimited resources and reputation needs should be evaluated in the organizational and industry context.⁵⁶ For example, a financial analysis may be the basis of the decision as to whether the company should quit an outsourcing deal or pursue an emerging geographical market. At times, a resource evaluation can influence the choice

between a risk avoidance and a risk mitigation strategy; and the company may decide only to reduce the likelihood and impact of events with reputation effects to a tolerable level, even though that does not assure absolute reputation capital protection.

The consistency of a response strategy with long-term business objectives.

It is the responsibility of the board to ensure that the choice of a certain response strategy is the most appropriate to protect and enhance corporate reputation for the long term and is not induced by short-term, partisan considerations (such as the remaining tenure of a chief risk officer or the vesting period of stock options awarded under existing executive compensation plans). In particular, the board should be skeptical of any attempt at restoring stakeholder confidence based exclusively on savvy communication tactics, and request that response strategies fully address underlying operational risks.

As discussed in *Emerging Governance Practices in Enterprise Risk Management*, once response strategies are set, companies need to avail themselves of educational platforms to cascade guidance and train risk owners and employees on strategy implementation.⁵⁷ The actual response implemented by functional or business unit managers should be aligned with the response strategy chosen as the most appropriate for that risk category. In addition, any actual response should fully leverage existing organizational processes, such as processes that are part of the internal control network, business planning procedures, Six Sigma controls and other quality-focused initiatives, compliance activities, etc. (Eventually, through a response strategy rationalization, the company should be able to eliminate low-value, redundant internal controls.) Finally, any actual response should be fully reported internally and be transparent to stakeholders and shareowners. This is where communication tactics and disclosure enhancement tools come into play in reputation risk management.

⁵⁵ For a discussion on the importance of immediacy in risk responses, see *Corporate Reputation: Not Worth Risking*, Knowledge@Wharton/Aon Corporation, 2005.

⁵⁶ For a methodology to assess organizational aspects of corporate reputation and optimize the use of internal resources, see Carl Bronn and Peggy Simic Bronn, "Reputation and Organizational Efficiency: A Data Envelopment Analysis Study," *Corporate Reputation Review*, Vol. 8, No. 1, 2005, p. 45.

⁵⁷ See Tonello, *Emerging Corporate Governance Practices*, p. 78 ("The Importance of an Educational Platform").

The Use of Communication Tactics to Corroborate Reputation Risk Response Strategies

This discussion led Corporate/Investor Summit delegates to the conclusion that a response to reputation incidents based exclusively on communication is flawed and may even aggravate reputation capital losses, as it avoids addressing the causative relation linking those losses to operational incidents. Instead, in a well-designed ERM program, communication tactics and better disclosure should be seen as tools to corroborate and complete a business risk response strategy.

By the same token, investor relation experts and communication specialists should not only be involved in the actual implementation of risk responses but also be invited to contribute to the conceptual design of response strategies. The board, in particular, should ensure that the ERM infrastructure welcomes this expertise and that communication officers (or external advisers, when needed) participate in the workings of the ERM Executive Committee and collaborate with executive risk leaders. Those in charge of designing risk management procedures should be able to fully leverage this added competence and analyze and choose a risk response strategy on the basis of the effectiveness of its communication to interested stakeholders.

For example, an important point debated by Corporate/Investor Summit delegates is whether it is good practice for a company's CEO to issue a public apology for an operational incident as well as what the form and substance of such apology should be. In the Sony laptop battery recall case,⁵⁸ many observers found that the CEO's apology was insincere since the company never admitted that the problem went beyond a very rare malfunction; reporters labeled the excuses "less than wholehearted" and "a middling of corporate obeisance." (See "Acts of Contrition," on p. 38.)

Delegates recommended that, in deciding whether and how to say sorry, chief executives and the board chairman should not rely on communication experts alone. Instead, the merit of a public apology should be discussed in an integrated risk management context and be part of a precise response strategy. In that context, the company could, for example, realize that an immediate apology would sound affected (if not self-interested) and only exacerbate the sentiments of certain key stakeholders – whereas the most appropriate action to show a sincere concern for the effects of a business incident is to promptly take the necessary steps, even where costly, to absolutely prevent any additional risk occurrence. Also, before making amends, executives should keep in mind that the *mea culpa* could be used against the company by litigious shareholders or third parties. (See the Wachovia example, on page 38.)

In conclusion, communication experts should be consulted, but the ultimate deliberation – and responsibility for the decision – should rest with the chief risk officer or those other risk management leaders who have a full understanding of the business risk and its causes.

Similar considerations should regard the decision on publicizing the company's use – as a risk response strategy – of public service initiatives (i.e., the initiatives developed by Johnson & Johnson in response to the Tylenol scandal). At a minimum, when adopted, such initiatives should be implemented and communicated in a manner inviting observers to attribute them to the disposition of the corporation (i.e., a sincere demonstration of concern) rather than to situational constraints.⁵⁹

⁵⁸ See Appendix I ("Case Studies,") on p. 43.

⁵⁹ Andrea M. Sjovald and Andrew C. Talk, "From Actions to Impressions: Cognitive Attribution Theory and the Formation of Corporate Reputation," *Corporate Reputation Review*, Vol. 7, No. 3, 2004, p. 269.

Acts of Contrition

1982 – Johnson & Johnson’s executives apologized profusely for the Tylenol contamination incidents. The public was won over by those concrete initiatives (voluntary donations to families of the victims, executives’ visits to hospitals, etc.) with which the company showed its sincere contrition for the situation.

June 2005 – Ken Thompson, Wachovia’s chairman and chief executive officer, expressed his regret for the company’s historical connection with the slave trade, stating that he was “deeply saddened” by the discovery and apologizing “especially to African-Americans and people of African descent.” A Chicago ordinance had required Wachovia to look through its history for any relationship to slavery as an act of discovery related to a civil lawsuit on slave reparations. A string of other lawsuits followed the public admission by the bank.

February 2006 – Amid a state investigation over alleged illegal corporate transactions, Lee Kun-Hee, Samsung’s founder, issued what he called a “statement to the people of South Korea” and offered to donate 800 billion Korean won, or \$825 million. He said the group would leave it to the nation to decide where the money should go. Separately, Samsung will keep its annual program, estimated at 200 billion won, to build orphanages and libraries, and to help homeless people and farmers.

September 2006 – In a press conference in Palo Alto, Mark Hurd, Hewlett-Packard’s CEO, apologized for what he called “very disturbing” corporate improprieties related to the pretexting scandal that prompted criminal and congressional investigations. However, some have pointed out that the

apology sounded equivocal when Hurd added: “As of today, we still do not have all of the facts. I also *cannot guarantee that we will ever be able to obtain all of the information regarding this investigation.* This is due to its complexity, the number of people involved, with many of them outside the company.”

October 2006 – In response to the option backdating revelations, Steve Job, Apple’s CEO, admitted that he knew about the bookkeeping practices but was unaware of their accounting implications. The press praised Jobs for the following statement, with which he took full responsibility for the incident: “I apologize to Apple’s shareholders and employees for these problems, *which happened on my watch.* They are completely out of character for Apple. We will now work to resolve the remaining issues as quickly as possible and to put the proper remedial measures in place to ensure that this never happens again.”

October 2006 – Sony apologized for the inconvenience caused by its global recall of laptop batteries, but said that the problem had been resolved and that no top executives would resign over it. In an article published by *The Economist*, Sony’s statement was labeled as “less than wholehearted” and “a middling of corporate obeisance.”

Sources: “A Gesture of Remorse from Head of Samsung,” *International Herald Tribune*, February 7, 2006; “No Longer the Hardest Words for Sony,” *The Economist*, October 25, 2006; “Steve Job’s Apology: A How-To Lesson in Corporate Governance,” *seekingalpha.com*, October 6, 2006; “Chairman Out at HP; CEO Takes Position,” *Washington Post*, September 23, 2006; “Corporate Cowardice Backfired,” *The American Spectator*, June 22, 2005.

The Use of Disclosure Enhancement Tools to Strengthen Long-term Corporate Reputation

A firm's reputation depends on its truthfulness and transparency vis-à-vis its key stakeholders. However, in a market driven by powerful, multimedia advertising campaigns, a dichotomy between corporate identity and public reputation is – to a certain extent – innate in doing business and unavoidable by any organization. What matters is that risk response strategies (and communication tactics adopted as part of those strategies) do not widen the identity/reputation gap to the point of exposing the firm to a new, and even bigger, reputation risk. For example, many commentators noted that the publicity that British Petroleum made of its metamorphosis into the environmentally conscious Beyond Petroleum only accentuated the reputation damage caused by the most recent series of accidents; in fact, in the press, BP has been accused of having “greenwashed” its corporate image while continuing its usual business practices.⁶⁰

Since they are subject to strict compilation requirements and accuracy checks, SEC filings and other public disclosures to shareholders ultimately guarantee that a firm's reputation is not only the outcome of well-engineered publicity and communication schemes.⁶¹ The responsibility of audit committees and other directors to oversee the effectiveness of internal controls and disclosure procedures is therefore relevant even from a reputation risk governance standpoint. Directors should reach an objective opinion as to whether the portrait of the company contained in disclosure documents reflects the essence of the business and is truly honest to shareholders, prospective investors, and other interested persons. In particular, board members should encourage prompt notice to shareholders – through a Form 8-K filing – of the

occurrence of material corporate events that were not previously disclosed, as well as oversee the adoption of strict internal policies on communication with market participants and operators (i.e., analysts, brokers and dealers, investment advisors, institutional investors, etc.) to avoid a situation where business information not yet made public is leaked to a select group of outside individuals.⁶²

Studies indicate that, on average, only 25 percent of a company's market value can be attributed to accounting book value, while the remaining 75 percent consists of intangible assets and expectations of future growth.⁶³ Public filings seem particularly laconic on risk and risk management. According to research conducted by Deloitte in 2005 on SEC-registered companies, risk factor disclosures included in periodic corporate reports are often inconclusive as they:

- do not attempt an analysis of the interdependencies among risk factors and their effects, including the effects on the firm's reputation and its stakeholder relations (whereas 80 percent of all major corporate value losses are shown to be due to a chain of events or the simultaneous occurrence of multiple events);
- fail to elaborate on and quantify the link between risk occurrence, reputation consequences, strategic objectives, and enterprise value.⁶⁴

⁶² On Form 8-K filings, Regulation FD requirements, and the liability arising from including false statements in public disclosure documents, see Matteo Tonello and Carolyn K. Brancato, *Corporate Governance Handbook 2007*, pp. 75-79 and footnotes.

⁶³ See, for example, John Ballou, Roland Burgman, and Michael J. Molnar, “Managing for Shareholder Value: Intangibles, Future Value, and Investment Decisions,” *Journal of Business Strategy*, Vol. 25, No. 5, 2004, pp. 17-22; Baruch Lev, “Remarks on the Measurement, Valuation, and Reporting of Intangible Assets,” *Economic Policy Review* (Federal Reserve Bank of New York), September 2003, p. 17; and Robert Eccles, “The Performance Measurement Manifesto,” in *Measuring Corporate Performance*, Harvard Business School Press, 1991.

⁶⁴ Rick Funston, Deloitte & Touche LLP, “Preliminary Analysis of Publicly Reported Risks,” Presentation to The Conference Board Working Group on ERM, New York, November 2, 2005. The project analyzed annual reports (10-Ks, 10-Qs, and 20-Fs) of 266 companies (144 of which belong to the S&P 500 index). Also see Mark Layton and Rick Funston, “Disarming the Value Killers: A Risk Management Study,” Deloitte Research, 2005.

⁶⁰ “Behind the Spin, the Oil Giants Are More Dangerous Than Ever,” *The Guardian*, June 13, 2006, commenting on the green re-branding of BP and Shell.

⁶¹ By the same token, corporate reputation is proven to work as an effective constraint on deliberate corporate misinformation; see, for this conclusion, Gary Charness and Nuno Garoupa, “Reputation and Honesty in a Market for Information,” Universitat Pompeu Fabra Economics Working Paper No. 326, September 1998, available at www.ssrn.com/abstract=139695.

Because of these limitations, public disclosure on risk contributes very little knowledge to the investment process and is often overlooked by financial analysts.

Considering the intangible nature of reputation capital, the board should discuss how to go beyond pure financial reporting and enhance the quality of public communication with stakeholders so that the value of corporate reputation (as well as of any risk response strategy devised to protect it) is better acknowledged by the market and other interested parties. In order to do so, companies need to review their information-supply chain (that is, their set of enterprise-wide pro-

cedures meant to select relevant business information, process it, and describe it in plain English) and fully embed it in their ERM program. Specifically, corporations should become familiar with extra-financial measurements of performance and consider adopting innovative methodologies (including the AICPA's Enhanced Business Reporting) to report on those measures to stakeholders.⁶⁵

⁶⁵ For an overview of new trends in enhanced disclosure, see Allen White, *The Quiet Revolution in Business Reporting*, CERES, Inc., April 2007.

Public Disclosure Oversight

The corporate board is responsible for the oversight of procedures for the preparation of disclosure documents, whereas management should be held accountable for the procedure implementation. With respect to financial statement, and internal controls in particular, board oversight responsibilities are typically delegated to the audit committee. But all directors should review and be satisfied with existing disclosure procedures without assuming that, simply because the procedures have been used and tested over the years, they are accurate and effective. Ultimately, it is the board's responsibility to foster public communications that are complete, fairly represent material information, and comply with applicable laws and regulations.

Board members need to feel comfortable with any public document submitted to their review and must be prepared to ask questions on the methodology used to develop it. As the SEC has stated on number of occasions, "Officers and directors who

review, approve, or sign their company's periodic reports must take steps to ensure the accuracy and completeness of the statements contained therein, especially as they concern matters within their particular knowledge and expertise. To fulfill these responsibilities, officers and directors must be vigilant in exercising their authority throughout the disclosure process" (SEC Release No. 34-39157, September 20, 1997). Since the periodic report or a proxy statement may contain indicators that the preparation process is flawed, it is good practice for every director to carefully review the final draft of major disclosure documents before their public filing, focusing in particular on any content about which the director is especially knowledgeable.

Source: Matteo Tonello and Carolyn K. Brancato, *Corporate Governance Handbook 2007*, p. 76, The Conference Board Research Report R-1405-07-RR.

The Enhanced Business Reporting Initiative in the United States

In 2002, for the purpose of complementing and enhancing corporate financial statements and management commentaries (i.e. management’s disclosure and analysis, or MD&A), the board of directors of the American Institute of Certified Public Accountants (AICPA) launched a proposal to establish a collaborative effort among a large number of international stakeholders. In January 2005, the Enhanced Business Reporting Consortium (EBRC) was founded as a not-for-profit and independent collaboration of investors, creditors, analysts, management, directors, academics, and standard-setters charged with developing an EBR framework. The Conference Board Governance Center joined the EBRC as a strategic partner in the summer of 2005.

On October 18, 2005, a first exposure draft of the EBR framework was released for comments from the business reporting community. Its structure includes four broad categories of extra-financial disclosure: business landscape, strategy, competencies and resources, and performance (see Table). Each category is then articulated into a number of disclosure items. It should be noted that the framework contemplates risk management as an item of disclosure on strategy.

Enhanced Business Reporting Framework

<i>Level 1</i>	<i>Level 2</i>
Business	Overview
Landscape	Competition
	Customers
	Technological change
	Shareholder relations
	Capital availability
	Legal
	Political
	Regulatory
Strategy	Business model
	Organization
	Governance
	Risk management
	Environmental and social
	Business portfolio
	Resource allocation
	Product life cycle
Competencies & Resources	Key processes
	Customer satisfaction
	People
	Innovation
	Supply chain
	Intellectual property
	Information and technology
	Financial assets
	Physical assets
Performance	Profitability
	Liquidity
	Operating

Source: Tonello, *Emerging Governance Practices*, p. 86. Also see *The Enhanced Business Reporting Framework. Public Exposure Draft*, October 2005. The draft can be downloaded at www.ebr360.org.

Delegates to the Corporate/Investor Summit endorsed the following recommendations on the role of the corporate board in the oversight of communications on corporate reputation and reputation risk response strategies:

- The need for a high-level discussion on how to set an ERM competitive advantage and convey to key stakeholders the value inherent in embedding corporate reputation safeguards in the company's ERM effort.
- The need to ensure that ERM is fully integrated with existing disclosure procedures so that any material, nonconfidential information on business risk and its reputation effects is captured and adequately communicated to the market.
- The need to be satisfied with the transparency of the disclosure process. Specifically, the board should verify that any individual involved in the risk management program is in a position to raise concerns regarding the accuracy and completeness of disclosed information on risk without fear of retaliation or retribution.

- The need to ensure that authorization and other verification protocols are in place so that the disclosure of qualitative, extra-financial performance measures is not manipulated in the information-supply chain.⁶⁶

Reporting on business risks affecting corporate reputation and on reputation enhancement strategies can also contribute to changing the markets' focus on short-term earning projections. "The overemphasis on quarterly earnings can decline as companies report transparently on their key drivers of value creation. Long-term rewards will be tangible: a greater investor following, lower stock-price volatility, and ultimately a more attractive cost of equity or debt."⁶⁷

⁶⁶ For the prior endorsement of these recommendations by The Conference Board Research Working Group on Enterprise Risk Management, see Tonello, *Emerging Governance Practices*, p. 89.

⁶⁷ See the Enhanced Business Reporting Consortium press release of October 18, 2005 ("Enhanced Business Reporting Consortium to Promote Greater Transparency in Corporate Reporting"), citing Robert Eccles.

Appendix I

Case Studies*

Johnson & Johnson – Tylenol/cyanide deaths (affected stakeholder relations: customers; government) Johnson & Johnson’s swift response to the infamous Tylenol contamination incident (1982) – where seven people died after ingesting Tylenol capsules laced with cyanide – has become a classic risk management “best practice” and the most notable example of top-down, holistic approach to corporate reputation crises. In addition to immediately pulling from store shelves nationwide 30 million bottles of the product (at a cost of some \$100 million), the company coordinated a number of practical initiatives to show its sincere concern for any person who was poisoned. In particular, thousands of employees made over one million personal visits to hospitals, physicians, and pharmacists around the nation to demonstrate the absolute priority of customer safety among corporate values and restore faith in the integrity of Johnson & Johnson’s drug manufacturing process.

Within three months of the crisis, despite the initially huge public disquiet, the group had regained 95 percent of its pre-crisis market share. Twenty years later, in 2001, Johnson & Johnson ranked #1 on the Harris Interactive/Reputation Institute RQ Gold Survey of companies with the strongest reputation.

* Disclaimer: Case study descriptions included in this Appendix are based on corporate filings and business articles appearing in major publications, including: *The Economist* (www.economist.com); *The Financial Times* (www.ft.com); Harris Interactive (www.harrisinteractive.com); *The New York Times* (www.nytimes.com); *The Wall Street Journal* (www.wsj.com); *Wikipedia* (www.wikipedia.com); and *Yahoo Finance* (finance.yahoo.com). Case study descriptions were compiled for research purposes only and do not constitute the opinion of The Conference Board, The Conference Board Governance Center, or the author of this report. Johnson & Johnson, Nike Inc., Sony Corporation of America, Mattel Inc., and BP PLC are associates of The Conference Board.

Nike Inc. – Human rights concerns (activist groups) Since the mid-1990s, pressure from human right activists over working conditions in many of its Asian production facilities has led Nike to place more emphasis on corporate social responsibility and the corporate brand as distinct from the Nike product brand.

Despite boycott campaigns led in several parts of the world, especially by anti-globalization groups, Nike’s annual revenues have increased from \$6.4 billion in 1996 to \$15 billion in 2006. On the other hand, the company’s relation with activist groups remains strained. Most recent sources of criticism include Naomi Klein’s popular book *No Logo* and Michael Moore’s documentaries.

Sony Corp. – Laptop battery recall (customers; business partners; government) Since April 2006, Japanese electronics maker Sony effected a series of recalls of lithium-ion battery packs for laptop computers, amid reports of overheating problems and minor explosions. The problem appeared to be due to the contamination of batches of cells on a production line with metal particles and other impurities that could cause short-circuits and fires. All major PC manufacturers using Sony’s cells (including Apple, IBM, Dell, Toshiba, and Fujitsu) also announced a replacement program.

Overall, more than 7 million units were recalled worldwide at an estimated cost of \$340 million. The incident called the attention of the market to Sony’s underperforming (and highly indebted) game division and the struggle to complete a company-wide restructuring plan. The group’s estimated profits in the year to March 2007 plunged 68 percent.

Case studies summary table

Case	Reputation* Ranking 2006	Business Risk	Directly Affected Stakeholder Relation(s)	Main Risk Response
Johnson & Johnson	13	Product safety	Customers; government	Product recall; sincere demonstrations of concern
Nike Inc.	25	Outsourcing risk	Activist groups	Emphasis on separation between corporate brand and product brand; socially responsible initiatives
Sony Corp.	8	Production oversight	Customers; business partners; government	Product recall; adhesion to PC manufacturers' replacement programs; CEO's public apology
Mattel Inc.	Not surveyed	Outsourcing risk	Customers; government	Product recall; adoption of more rigorous outsourcing standards
BP plc	52	Environmental/ Health & Safety	Activist groups; local communities; employees; government	Re-branding; environmentally-friendly business initiatives; replacement of head of U.S. operations
Martha Stewart Living Omnimedia Inc.	52 (2005)	Strategic risk	Shareholders; customers	Development of theme-based contents to reduce dependence on founder

* Source: Harris Interactive, Inc.

The company's response encountered harsh criticism by the press, consumer associations, and governmental agencies. Many observers found that the CEO's apology to be affected and insincere; reporters labeled it "less than wholehearted" and "a middling of corporate obeisance" (*The Economist*, October 25, 2006). Sony reassured customers that the problem was limited to a very rare malfunction; that almost all recalled batteries were, in fact, perfectly safe; and that the decision to recall was justified by Sony's utmost concern for its products' users. However, the Battery Association of Japan, an organization of Japanese battery manufacturers, issued a statement that "a big problem is that Sony has not provided sufficient information to allow the industry association to determine whether the problem is specific to Sony or whether it has broader implications." Similarly, the Japanese Ministry of Economy, Trade and Industry complained about Sony's refusal to offer "a satisfactory explanation" of the incident.

Finally, Sony stated that it was willing to share recall expenses with PC manufacturers using Sony's batteries. Nonetheless, as a result of the difficulty to reach such an agreement, some notebook makers threatened to bring legal action against Sony to recover losses (including reputation damages).

Mattel Inc. – Toy recall (customers; government)

In August 2007, Mattel recalled hundreds of thousands of toy cars daubed with lead-based paint and more than 18 million dolls and other toys containing small magnets which could come loose and be swallowed by children. The recall was Mattel's second of the month. Earlier, the company's Fisher-Price unit had found lead paint on its toys. The estimated cost of the product recall exceeded \$50 million; the announcement prompted a 6 percent fall in Mattel's share price, although the stock recovered in the following days.

As part of its defense, Mattel explained that flawed items were manufactured by Chinese subcontractors. However, some politicians in the United States and other detractors of loose outsourcing practices to foreign countries with lower production costs observed that Mattel's orders are large enough to give the company the negotiating power to set rigorous standards and conduct regular inspections. The incident also affected the company's relation with regulatory agencies, both in the United States and China. For example, the U.S. Consumer Product Safety Commission issued a statement indicating that it was having "ongoing and rather aggressive conversations" with Mattel and other U.S. toymakers to learn more about their outsourcing practices and enforce a program to test toys before they are imported. On its part, the China Chamber of Commerce added that the problem was due to the "irresponsible behavior of some individual companies, not only Chinese," and encouraged the Chinese toy industry to "exercise self-discipline" by not accepting orders from foreign companies that pay little and have unclear quality demands.

BP PLC – Poor environmental and safety records (activist groups and local communities; employees; government) By the time BP was plunged into crisis by a string of disasters in 2005 and 2006 (including Alaska's largest ever land oil spill and a refinery explosion in Texas City that killed 15), the oil giant had been dealing with reputation issues for years. In 2001, the company was named one of the 10 worst corporations based on its environmental and human rights records. According to Corporate Watch, the combination of the company's own emissions with those generated by the products it sells makes BP a greater polluter than Central America, Canada, or Britain. Although the oil industry as a whole engaged in widespread cost reductions in the 1980s and 1990s, no other oil company has suffered so many high-profile accidents as BP in the last five years.

A number of actions were adopted, over the course of time, to repair the company's image, but the reputation enhancement strategy did not always proved successful. In February 2002, to respond to accusations of political entanglement, Lord Browne of Madingley, BP's then global chief executive, renounced the prac-

tice of campaign contributions. The following month, the CEO gave a highly publicized speech about the reality of global warming and the urgency of an intervention by the corporate community. Also in 2002, in an attempt to emphasize the organization's interest in alternative and environmentally-friendly sources of energy, British Petroleum changed its name to BP, introduced the new "Beyond Petroleum" corporate slogan, and replaced its "green shield" logo with a helios symbol (a green and yellow sunflower pattern). The head of BP Alaska was transferred soon after the 2006 disaster; a newly appointed head of U.S. operations became vocal about the discrepancy between unsound safety practices developed by BP's U.S. unit and the group's overall values; and Lord Browne was forced by the Chairman of the board to announce his early retirement in 2008 (he then resigned in the summer of 2007 amid accusations of having operated in conflict of interests).

Despite these actions, the company is still struggling to regain the trust of investors, activist groups, and governmental authorities. For example, senior management is being regularly criticized by the press for "greenwashing" BP's corporate image while maintaining environmentally unsound practices (*The Guardian*, June 13, 2006). In September 2006, the U.S. House of Representatives energy committee subpoenaed BP's top management for a hearing on how their U.S. assets could have suffered such severe deterioration. Also in 2006, BP made again the list of 10 least reputable public corporations in the world. Finally, some investors and research analysts were puzzled by the group's decision, after the 2006 accidents, to maintain a decentralized organizational structure that had clearly encouraged a culture of deceit among business unit managers, poor safety standards at the periphery, and a lack of operational knowledge by senior executives. To the contrary, the 1989 Valdez oil spill had induced ExxonMobil to restructure itself into a number of functional lines that centralize controls and reporting and spread best practices and technology rapidly across the firm's ranks. According to many observers, ExxonMobil owes to this fundamental organizational decision its current status of acknowledged global leader in the industry for safety and engineering excellence.

Martha Stewart Living Omnimedia Inc. – Unethical behavior (shareholders; customers) When the corporate brand is an individual reaching celebrity status, unique reputation challenges can arise. Many businesses (especially in the fashion and entertainment sectors) are closely associated with their founders. However, this association can pose serious corporate reputation threats when it becomes a real dependence. In the case of Martha Stewart Living Omnimedia (MSLO), Martha Stewart was so inextricably linked to the company's core products and services (which span publishing, television, merchandising, and Internet commerce) that the securities offering memorandum for MSLO's IPO in 1999 warned investors as follows: "Our business would be adversely affected if Ms. Stewart's public image or reputation were to be tarnished."

Nonetheless, the company started to take serious steps to manage such a critical reputation risk only as a reaction to the federal investigation over the infamous ImClone insider trading case. Among these steps: Ms. Stewart was taken off the cover of its flagship publications (including Martha Stewart Living magazine); she was no longer extensively featured in the

contents while theme-based stories became prevalent; her picture was removed from Internet advertising banners and the packaging of products sold at K-Mart (one of MSLO's major merchandise distributors); finally, on March 15, 2003, immediately after her conviction, Ms. Stewart resigned from her position as a director and chief creative officer of MSLO and renounced any operational role in the company she had founded.

MSLO paid a high price for being merely reactive to its core reputation risk issue. By the time these actions were fully implemented, it was too late. Martha Stewart's investigation, indictment, and trial lasted many months. On March 13, 2003, MSLO reported a 31 percent revenue drop (its first ever earnings loss) due primarily to withdrawal of major advertising sponsors and the cancellation of *Martha Stewart Living* syndicated TV show. Expenditures, on the contrary, were driven upwards by the need for extensive public relation services and legal advice. For about two years, the company's stock was seriously penalized and traded at a price range equal to about half the price of the initial public offering.

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