Reputation loss: a palpable intangible asset liability

A lost reputation can cost a company billions of dollars; the personal implications for its directors are equally as serious

By **Nir Kossovsky** and **Urmi Ashar**

"The board is tasked with enterprise risk governance," observed a worried corporate director. "But it seems that the board is also supposed to help build reputation; that is daunting." And, if we may opine, a matter requiring immediate attention; for failure to do something constructive in the near term may expose a director to personal liability and a damaged personal reputation.

This article summarises the proceedings of a recent conference convened by the Three Rivers Chapter of the National Association of Corporate Directors with the express intent of stimulating a broad conversation to capture the thinking of corporate directors with regard to managing an ephemeral and highly valued attribute – reputation – at both the personal and corporate levels. Panellists were the Honourable Cynthia A Baldwin, general counsel of Pennsylvania State University, director of Koppers Holdings and immediate past chair, Association of Governing Boards of Colleges and Universities; William Hernandez, a director of Albemarle, Black Box, Eastman Kodak Company and USG Corp; George Long, chief governance counsel and corporate secretary, The PNC Financial Services Group; and George L Miles Jr, director of AIG, HFF, Harley-Davidson, WESCO International and EQT.

Rising value of reputation

The word reputation carries varied meanings, depending on the context. "Reputation is the way that others see the company," said panellist Baldwin. Since it is an impression held by stakeholders, a useful idea for the purposes of both risk management and value creation is this: reputation is that which creates a future expectation that concurrently shapes a present behaviour.

Those impressions held by stakeholders arise from how well a company husbands the various business processes that differentiate one firm from another. Those processes include how a company fosters an ethical environment, promotes innovation, conforms to standards of quality and meets expectations for safety, security and sustainability. The stakeholder behaviours that are shaped by reputation include purchasing goods and services preferentially, ideally at a price premium; providing superior supplier terms, accepting lower wages and creating less internal friction; providing more favourable credit terms; and bidding up equity value to higher earnings multiples.

The value of reputation has risen over the past two decades in parallel with the risk in enterprise value in excess of tangible book value. "It's an intangible (asset)," noted Hernandez. In the 1980s the average intangible asset value of a constituent member of the S&P500 Index was around 20%. In 2010 the average value was around 80%. Which is why, in late 2008, as Lehman Brothers was about to give up the ghost, then-Federal Reserve Chairman Alan Greenspan observed: "In a market system based on trust, reputation has a significant economic value."

In metrics, deeds and words

Reputation is a mirror on a company's soul. "It's tied to corporate culture," explained Hernandez. "You can't tout a reputation that your corporate culture doesn't support." As those who were once on the "trustworthy" side of 30 used to say: "Be authentic." Being authentic means measuring that which is managed, defining processes that advance reputation objectives and communicating transparently the efforts, successes and failures to all key stakeholders.

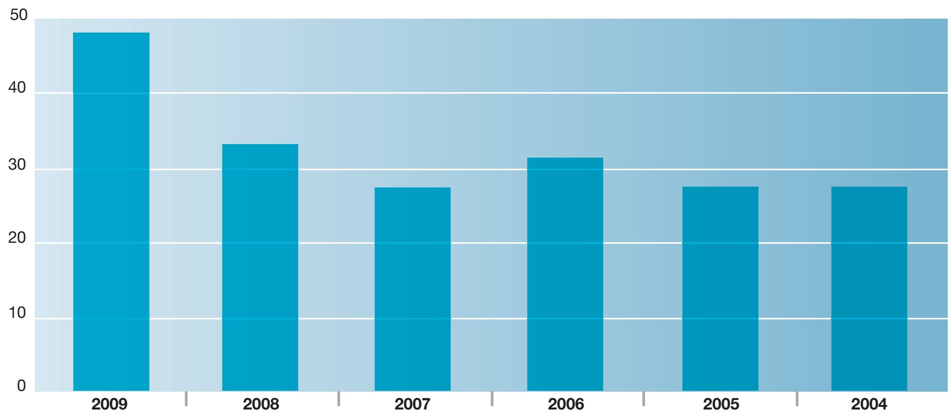
Finance/metrics/incentives
Fostering conformance with behaviours that enhance reputation value is a key success factor. A robust system of financial metrics requires measuring instruments that can track, acknowledge and reward the creation of intangible asset value. Monitoring these instruments for intangible asset values mitigates enterprise-wide risk. Measures of success include various financial and survey-driven reputation indices and metrics on one hand, and traditional financial statements on the other. For reputation upgrades are soon reflected in market share and pricing power, reduced operating costs and internal friction, better vendor and creditor terms, a higher net income, lower beta and higher earnings multiples.

Operational excellence
Acquiring an excellent reputation that is both sustainable and resilient occurs only in the setting of operational excellence. One major barrier to developing processes that enable operational excellence is a near-universal operational-level fear of instituting a bureaucracy in firms that have historically operated by the seat of their pants. Creating an employee-led taskforce charged with the mission of achieving operational excellence may not necessarily overcome the complementary barriers to update existing practices or introduce new practices that better support reputation in firms that have an established bureaucracy.

Therefore, in the spirit of Kaizen (continuous improvement philosophy) and other workgroup-level initiatives, packaging the efforts in an attractive wrapper can make all the difference. Here are three Ps that provide a goal-oriented framework for the taskforce charged with achieving and monitoring operational excellence:

- **Problem solving** – figuring out how to do what you do more ethically, safely, etc in a way that creates value.
- **Preparation** – determining how to make the training in (a) of executives new to the firm easy, effective and not burdensome.
- **Preservation** – developing an approach that managers can use to gently encourage/remind/reward people of (a) in a way that can also catch slippage without being obtrusive.

Figure 1. **Number of companies comprising constituent members of the December 2009 S&P500 Index that disclosed each year in their 10Ks Section 1A that reputation was a material risk**



Source: **James Singer, Pepper Hamilton**

Coherent communications
A number of companies operate with a fully integrated communications platform. Others lack even the most basic elements, such as a corporate image book, set of language standards and other elements of communication. Communications silos in the areas of product marketing, investor relations and corporate communication are sources of messaging risk and therefore enterprise value risk. Both internal and external communications need to be harnessed coherently to ensure that stakeholders are unambiguously apprised of the two elements described above in a way that will allow them to appreciate and value them. For lack of a better phrase, call it enhanced stakeholder relations.

If not greed, then fear
There is a growing library of empirical data affirming the positive association between superior reputation management and the creation of increased enterprise value. In fact, reputation's growing importance to enterprise value was not lost on the courts and the world of governance where the director's duty of loyalty expanded materially in 2006. Historically, the duty of loyalty came into play only in cases involving conflicts of interest – for example, when a director stood on both sides of a transaction under consideration by the board and stood to benefit personally from it. According to Cathy Reese, a partner with law firm Fish & Richardson and chair of the Intangible Asset Finance Society's Committee on Intangible Asset Governance, the Delaware Supreme Court's 2006 opinion

Table 1. **There are six key business processes (intellectual properties) that create, preserve or restore reputation value**

Create an ethical work environment	Ethics are the moral principles by which a company operates; integrity is the act of adhering to those moral principles. Ethics are an integral part of governance that combine with integrity to affect the reputation value of all other intangible assets. Additionally, ethics are the keystone intangible asset because they form the basis for trust and confidence.
Drive innovation	Innovation is the design, invention, development and/or implementation of new or altered products, services, processes, systems, organisational structures or business models for the purpose of creating new value for customers and financial returns for the firm.
Assure quality	Quality is: • The extent to which a product is free from defects or deficiencies. • The extent to which a service meets or exceeds the expectations of customers or clients. • The extent to which products and services conform to measurable and verifiable criteria.
Uphold safety	Safety is the state of being certain that a set of conditions will not accidentally cause adverse effects on the wellbeing of people or the environment.
Promote sustainability	Sustainability means making, using, offering for sale or selling products and services that meet the needs of the present without compromising the ability of future generations to meet their own needs.
Provide security	Security is the degree of protection that a company offers against events undertaken by actors intentionally, criminally or maliciously, for purposes that adversely affect the firm. Because fear is the great disruptor of life and commerce, it is useful to think of security, the most ethereal of the intangible assets, as "absence of fear".

Data source: ***Mission: Intangible. Managing risk and reputation to create enterprise value*** **(IAFS, 2010).**

in *Stone v Ritter* adopted the concept of oversight liability, which had been discussed some 10 years earlier in the influential 1996 *In re Caremark* decision by the Delaware Court of Chancery. Importantly, this duty of oversight applies to all corporate assets, including intangible assets.

The court in *Stone v Ritter* stated that director oversight liability may be predicated on facts showing that either: "(a) the directors utterly failed to implement any reporting or information system or controls; or (b) having implemented such a system or controls, consciously failed to monitor or oversee its operations thus disabling themselves from being informed of risks or problems requiring their attention."

On 17th December 2010 a shareholder group filed a lawsuit against Johnson & Johnson's board, as well as managers, for an unspecified amount alleging failure to uphold their duty of oversight, breaching their duty of loyalty and allowing adverse events to proceed which inevitably "destroyed the company's hard earned reputation". According to Tony Chapelle, writing for the *Financial Times' Agenda Week*, "governance experts say that J&J's board should step in and more closely oversee the company's business processes in three vital areas: quality, safety and ethics".

Steel City Re's data show that the median cost of a headline risk event is about 7% of market capitalisation. But that may be underestimating the long-term costs, which will appear on the profit and loss in lines as diverse as unit sales, gross margins and operating costs, and credit costs. This may be why investor Warren Buffet famously said: "If you lose money for the firm by bad decisions, I will be very understanding. If you lose reputation for the firm, I will be ruthless."

There are two hooks in the above that should cause directors in the United States particular concern:

- Under Delaware law, corporations are not permitted to indemnify officers and directors against personal liability for breaches of the duty of loyalty.
- The collapse of a company's reputation can stain its directors' personal reputations. Panellist George Miles observed: "As a board member, as goes the company's reputation, so goes yours." Amanda Gerut affirmed this while writing for *Agenda Week*: "A director's involvement in a shareholder lawsuit at one company could create concerns that the negative attention will spill over onto the other boards on which he or she serves." Empirical data indicates that the number of board seats held by independent directors drops three years after a shareholder lawsuit has been filed.

There are any number of explanations for why Oxford Metrica estimates that the five-year risk of a reputation event is 82%, why German financial regulators now require capital reserves for reputation risk and why almost 10% of the S&P500 constituent members disclosed "reputation risk" in Section 1A of their 2009 10Ks—nearly twice as many as in 2007 (Figure 1). One of those is the rise of social networks and the ease of access to information that underpins reputation. "Today, it's just easier to damage a reputation," observed panellist

Figure 2A. **Reputation in decline. Graph of the trailing 30 months shows, beginning in mid 2009 (in red), the slow decline of Johnson & Johnson's reputation ranking relative to 78 peers comprising pharmaceutical sector companies valued at greater than US$1 billion, as of 6th January 2010, as determined by the Steel City Re Corporate Reputation Index. Shown in blue is the slow, steady decline of the average ranking of the 78-member pharmaceutical sector relative to approximately 9,000 publicly traded companies on the main US and European exchanges**

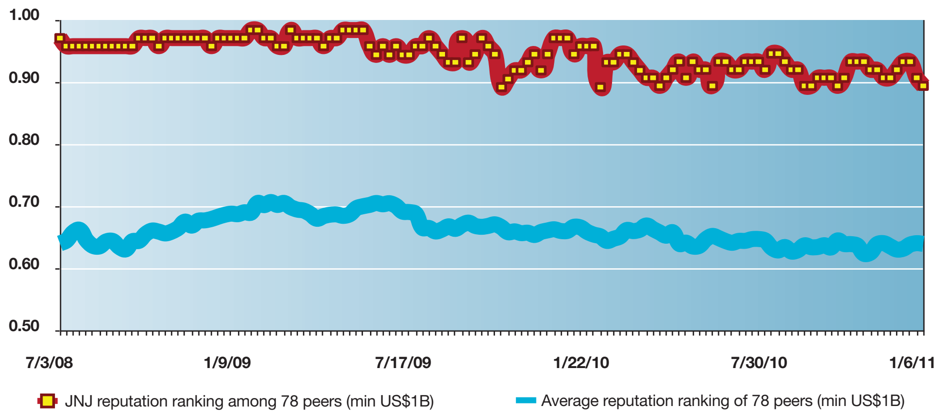
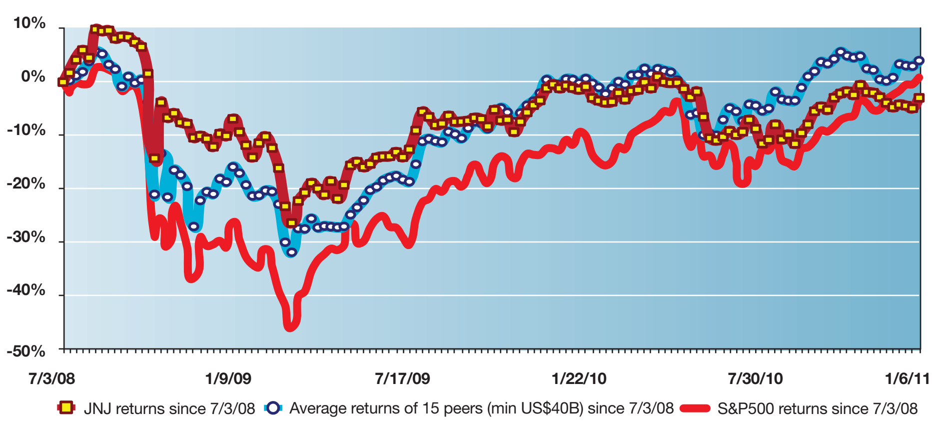


Figure 2B. **Slow relative economic decline. Graph shows (in red) the slow decline of Johnson & Johnson's relative return on equity compared to 15 peers (in blue) comprising pharmaceutical sector companies valued at greater than US$40 billion as of 6th January 2010. Also shown is the period return of the S&P500 Composite Index. During the 30 months shown above, Johnson & Johnson's economic returns progressively decreased relative to its peers, from outperforming them prior to mid 2009 to parity until mid 2010, to underperforming as of January 2011. The difference between the two sets of returns is about 7% – coincidentally, the median cost of a headline risk event. The S&P500 returns over this 30-month period are essentially zero**



Source: **Steel City Re**

George Long. As Michael Skapinker, writing for the *Financial Times*, noted: "Blogs and Twitter keep up a relentless patter. But what really hurts is round-the-clock television. Those hours need to be filled with supposed experts who are expected to say what is happening before they can possibly be sure. It rankles with companies, but is not going to change."

Board-level corporate reputation protection

What lessons can we draw? First, a headline-grabbing reputation crisis lurks in every organisation. BP is in a business where safety and sustainability are regularly challenged, but Enron, Worldcom and HP ran into problems over ethics. AIG ran aground because the complexity and

“Reputation risk is an operational risk, and therefore reputation risk management is an integral part of enterprise risk management”

interconnectedness of its financial innovations defied pre-crisis analysis. Heartland Payment Systems suffered from a cyber-security breach; Toyota’s problem was quality from within its supply chain.

This means that awareness of a company’s entire commercial network is the watchword. “A little paranoia is good for a board,” notes Hernandez. Partners, suppliers and licensees, from the perspective of reputation, are major sources of reputation risk. Just ask Mattel, the toy manufacturer, whose iconic dolls were made toxic by lead paint.

Rolls-Royce, the manufacturer of mission-critical power systems, discloses that its board-driven asset preservation policy acknowledges the priority of the three greatest things it is protecting: “Reputation, viability and profitability.” The company has layers of risk management and quality oversight systems in place from the board down to the distant members of its supply chain.

It is unquestionably serious about quality and reputation. This is evident from its concrete actions to rectify critical engineering problems that triggered a catastrophic mid-flight explosion of one of its Trent 900 engines. Within an eight-week period, the company disclosed that an oil leak was the presumptive cause of the explosion, identified the source of the leak, determined the mechanism by which the leak occurred, identified the systemic source of the problem that could affect all Trent 900 engines and rectified the problem. For sceptics looking for external validation that the problems were satisfactorily resolved, there are two: eight weeks after the explosion, British Airways Plc, Europe’s third-biggest airline, agreed to buy Trent 900s for 12 A380s, to be delivered starting 2013; and the company’s stock price was higher than it was the day before the explosion.

Oversight systems, properly disclosed as evidence of authentic corporate concern over quality or other intangible asset business processes, provide two benefits. First, they satisfy director obligations under the duty of loyalty. Second, and more importantly, they help to confer reputation resilience – the ability to withstand a headline event with little damage.

The second lesson is that communicating with stakeholders is a critical part of reputation management. Long observed: “You need to constantly communicate with your stakeholders. You need to be active in the community. If the first time that you come to them is in a crisis, you’ll have no credibility.” Miles added: “It’s important that a company builds up equity in its local communities. This will help it remain strong when actions occur that are outside of its control.”

When public, those communications need to be authentic and engaging, and affirm both an understanding of the problem and a commitment to rectifying the circumstances. BP did itself no service by saying that, while the catastrophic spill in the Gulf of Mexico was its responsibility, it was not its accident because a subcontractor had been running the rig. Nor did chief executive Hayward’s famous “I’d like my life back” remark endear the company to its many stakeholders who were experiencing the consequences of a safety-based event.

Yet communications need not always be public to be effective. Rolls-Royce was silent about its oil leak problems on the public front, other than an acknowledgement that an engineering problem was identified and repaired. From the executive team, there was no parade of executives, no blogs and no tweets.

“I’m not surprised,” remarked Jonathan Salem Baskin, noted brand marketer and author of the recent *Histories of Social Media*. “Rolls-Royce focused on analysing and fixing the problem, and was likely having behind-the-scenes candid conversations with numerous stakeholder groups involved in that operational reality. The world wanted the business focused on business, some outlier bloggers notwithstanding, and Rolls-Royce’s successes in its efforts were obviously recognised and valued.”

Reputation risk is an operational risk, and therefore reputation risk management is an integral part of enterprise risk management. “It’s a total board responsibility,” insists Miles. Like other areas of the business, reputation needs to be tracked parametrically and remediation steps need to be applied when values deviate outside accepted norms. Consider the example of Johnson & Johnson, a firm once recognised for its stellar reputation. Over the 30-month window beginning July 2008, Johnson & Johnson's Steel City Re Corporate Reputation Index ranking slid steadily from the 97th percentile among a cohort of its peers to just below the 90th percentile (Figure 2).

Also, as for other key operations that are monitored carefully and tied to executive compensation, management of corporate reputation should be tied to executive compensation too. It should be one of the key metrics used to measure performance. "If my corporation reputation gets damaged because of something that management did or did not do, then compensation should definitely be tied to that," opined Miles. At BP under chief executive Dudley, for example, safety metrics now underpin certain compensation regimens.

Companies must establish crisis management plans with operational and communications components. "Boards need to engage in a 'what-if' analysis – is the company prepared to deal with various situations?" said Judge Baldwin. And from conducting these exercises, boards will gain better insight into the questions they need to be asking of management before the reputation crisis strikes. "You should be talking about the underlying risks that affect your reputation," concludes Long. **iam**

Nir Kossovsky is chief executive of Steel City Re. **Urmi Ashar** is the founding president and chief executive of NACD Three Rivers Chapter
nkossovsky@steelcityre.com
uashar@nacdthreerivers.org

A video clip of the meeting reported in this article is available at: www.iafinance.org/_blog/MISSION_INTANGIBLE/post/Reputation_Corporate_directors_speak_%28video%29/

Action plan

Reputation management checklist for the board of directors. At board level:

- Corporate culture (eg, Rolls-Royce v BP (of old)).
- Oversight systems with financial metrics for key intangible assets.
- Executive-level compensation incentives.

At C-suite and operations level:

- P&L benchmarked metrics.
- Worker-friendly process development with oversight and incentives.
- Coherent communications.