GOVERNANCE

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Ireland – a ten-year governance journey

‘In 2015, Ireland has two legacies of its recession caused by poor governance to carry into the future – the first is a very large national debt to work through for many years to come – the second is a widespread awareness of what good governance means, and its value, not just in the corporate world, but across society as a whole.’

Alan McDonnell, Principal, Good Governance Solutions

CG statements: A case for change

‘At present the rules fail investors and other stakeholders by not mandating greater transparency in relation to the senior executive body – at a time when boards are drifting further towards a purely supervisory role – leaving the reader with an increasingly incomplete picture. For UK plc to retain its reputation as offering the gold standard in governance, a new approach is needed … The extension of the corporate governance discipline to the senior executive body is not a radical expansion of the UK governance model, but an essential means of achieving its central purpose.’

Haydn Main, Head of Legal, EMEA, Renaissance Capital

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Feature

Reputation risk revisited

Anthony Fitzsimmons and **Derek Atkins** offer a new definition of what constitutes reputation risk and suggest how to avoid it.

Everyone sees reputations as important and valuable, but reputation risk is poorly understood. As a result, most reputations are left at risk.

Historically, risk managers and internal auditors struggled to define reputational risk. Some saw it as the end result of the failure to manage other risks. Others saw reputational risk as a separate category of risk in its own right. What united both groups, and business leaders, was that reputational risk was the most serious risk facing their organisation; and that they had to avoid the kinds of outcomes that had regularly plagued and destroyed reputations in the past.

The upshot is a fudge. Most organisations treat a bad reputational outcome as a reputational risk without regard to its causes. Thus, for example, clothing retailers see stock made using cheap child labour as a reputational risk.

This approach is fundamentally flawed. Reputational damage does indeed happen when an organisation fails to manage other risks properly. But when root causes are considered, the deeper insight is that reputations are usually lost when stakeholders come to believe that the organisation is not as ‘good’ as they previously thought.

So what is reputational risk? To arrive at a sound answer, we must first ask what reputation is. Here is our definition:

‘Your reputation is the sum total of how your stakeholders perceive you.’

This definition emphasises four points.

1. Your reputation is about how you are perceived, which is not necessarily the same as how you really are;
2. Your reputation is not about how you perceive yourself; it is about how your stakeholders perceive you;
3. If your stakeholders come to perceive you in another way, whether justifiably or not, your reputation changes.
4. That ‘sum total’ can vary depending on which stakeholders are most influential or relevant at any particular time.

Thus you lose your reputation when your stakeholders come to believe that you are not as ‘good’ as they thought you were. They judge you on human factors such as character, ethos, culture, trustworthiness, honesty, humanity, skill and competence. For an organisation they add whether it is coherent or dysfunctional.

A good definition of reputational risk is therefore:

‘Reputational risk is the risk of failure to fulfil the expectations of all of your stakeholders in terms of performance and behaviour.’

This emphasises the root causes of reputational damage, which are all to do with performance and behaviour.

Thus the reputational risk in the retailer example is superficially from using child labour. But answering the question ‘why?’ will reveal deeper causes, such as:

- the strategy of the company (eg buy as cheaply as we can);
- the ethos of the company (eg source cheaply – I am not interested how you do it);
- internal incentives (prioritising cost saving more than ethicality);
- leaders who don’t think about ethicality at all, and
- a dysfunctional organisation.

Risks such as these ultimately emanate from the board.

By tackling these root causes, you will not only avoid the known child labour risk. You will also prevent unknown future risks from those root causes. That is the approach that has made commercial aviation so safe that the most risky leg of a long overseas trip is the drive to or from the airports.

This insight is now widely recognised. It lies at the root of the latest Financial Reporting Council Guidance on Risk; and at the root of the growing emphasis by financial regulators on human behaviour as the origin of all financial failures.

The challenge is for organisations to find these often deep-rooted risks before they cause harm.

Our experience is that most business leaders are unaware of these risks and their implications. So too are many in risk teams. This is partly because behavioural and organisational risks are recent additions to the risk lexicon. But we regularly meet leaders and risk specialists who seem either complacent or unable to look under stones for fear of what they may find. Both are dangerous behavioural risk.

That is one reason why the latest FRC risk guidance encourages boards and risk teams to learn about these risks so they can find and fix them. With the right kind of education and evaluation, these lethal but under-recognised vulnerabilities can be dealt with before they cause harm.

Anthony Fitzsimmons is chairman of Reputability LLP. Professor Derek Atkins is a partner in Reputability LLP and Chairman of a City insurance broker. www.reputability.co.uk. Their book, Rethinking Reputation Risk, will be published in 2016 by Kogan Page.