Corporate Social Responsibility and Reputation Risk Analysis

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1. CSR: Key issues and Total Responsibility Management approach

The trend for better corporate governance and accountability has focused attention on the responsibilities an organization has not only towards all its stakeholder groups but also to the environment and society in which it operates.

In the last two decades the business community has concentrated on more and more transparency. This new trend for greater organisational accountability is the result of a growing demand for improved information on how organizations conduct their business in the current complex socio-economic context. Companies are amongst the most powerful social and economic institutions of modern society and, recently, their role has taken on more widespread functions, surpassing the traditional ones to include those belonging to the social and ethical profile.

The theme of Corporate Social Responsibility (CSR), and its internal and external communication, has been the centre of debates since the Sixties, above all in the United States. Only recently, due to increased pressure from stakeholders, has it taken place on a wider scale.

The concept of Corporate Social Responsibility, requested by an increasing number of international institutions – including the World Economic Forum and the World Business Council for Sustainable Development – is gradually becoming widespread in companies, adopting ethical influences in strategy decisions. The main aspects connected to a company's ethical responsibility within the European Union, have been highlighted in 2001 by the European Commission's Green Paper "Promoting a European Framework for Corporate Social Responsibility". Following this publication CSR can be defined as a concept whereby "companies integrate social and environmental concerns in their daily business operations and their interaction with their stakeholders on a voluntary basis". It is important to underline that being socially responsible means not only complying with relevant legislation, but also going beyond compliance and investing more than required into human capital, environment and relations with stakeholders[1].

At present, the approach to an enhanced sustainability is based upon the integration of a series of objectives which not only include those connected to economic performance, but also those which are ethically-socially and environmentally linked. Obviously, each organization is involved in CSR in its own way, depending not only on its core competences, resources and stakeholders' interests, but also on the culture and traditions of the area where the enterprise is located (Palazzi M., Starcher G., 2001).

This approach, known as *Triple Bottom Line* and represented by Sustainability Reports and/or by Social Reports, is part of "wider values" determined by social and economic values for all stakeholders, through the progressive expansion of social responsibility contents from the inside of an organization to the external environment (Testa M., 2004). An outline of this kind has led to a wide array of standards, guide lines and codes of conduct promoted by both the companies themselves as well as important international organisms. The central aim is to establish suitable tools for the diffusion of social-ethical management principles.

Therefore, the set of interdependent managerial tools and practices can be referred, in their whole, to a *modus operandi* that can be identified as *Total Responsibility Management* (TRM) (Gatti M., Testa M., 2003). It can be seen as a systemic approach to the management of a company's

[1] Practically, CSR builds on compliance with the legislative framework, which differs between countries, but focuses on the additional contributions from enterprises to meet societal expectations.

relationships with its key stakeholders and its treatment of the natural and social environment. TRM is built on widely-agreed upon foundation of values and three main elements can be identified (Waddock S., Bodwell C., 2002):

- vision setting and leadership system;
- integration of responsibility into strategies and practices;
- assessment, improvement and learning systems.

This approach is based on an integrated system used to address reliability; in fact, monitoring, improving and measuring performance helps companies maximize competitive success just as the *Total Quality Management* (TQM) approach has done for quality in the past. Building TRM approaches requires a foundation of generally agreed values, such as those outlined by the International Labour Organization conventions on labour and human rights or the principles of the United Nation's Global Compact which provide a broad guidance on ecological and social issues too.

However, as they also recognize a basic individuality of company vision, strategies and commitments, governance implementing TRM develops company specific approaches to responsible management that provide a framework to guide managers, without placing unnecessary constraints on their activities.

A clear vision on corporate responsibility from top management and well-articulated guiding core values that support the vision (Waddock S., Bodwell C., 2002) are necessary. An example of a comprehensive model for business ethics programmes is provided by the "Ten point program for implementing values driven management" by Driscoll and Hoffman (Driscoll D.M., Hoffman W.M., 2000). The two authors identify the following key elements for the successful development of any corporate values initiative: Self assessment; Commitment from the top; Code of ethics; Communication; Training; Resources; Organizational ownership; Consistent standards and enforcement; Audits and evaluation; Revision and reform.

Responsibility depends on the perspective of the particular stakeholder whose interests are under consideration. Consequently, responsibility management involves a process of meetings and dialogues with relevant stakeholders in order to establish a set of decision processes or results. As responsibility is defined by its impacts and how these are perceived by different stakeholders, companies need to know how well they are doing with respect to those different stakeholders.

Determination of responsibility requires a measurement and assessment system that provides a basis of understanding and information for internal stakeholders, like employees, and external stakeholders that hold a company accountable for its actions and their outcomes. This level of accountability implies the need for the integration of responsibility into strategies and the operating practices used to carrying out those strategies. It also implies a corresponding need for improvement and learning systems, built on feedback from holistic measurement systems, so when problems occur steps can be taken to improve the situation (Waddock S., Bodwell C., 2001).

As these are the main issues of CSR vision, the TRM can be seen as a very important approach in establishing management based on CSR values.

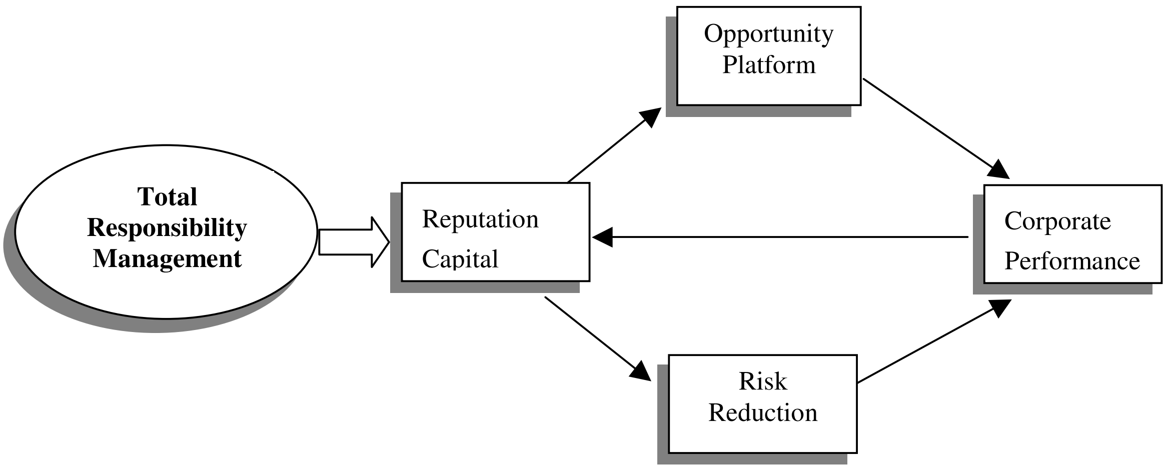
2. Reputation drivers: opportunities and threats

Generally**,** companies consider implementing responsibility systems too expensive and besides they can even lead to a number of disadvantages compared to their competitors. In fact, the cognitive assumption is that higher levels of responsibility will add to unrecoverable costs, because the costs related to an irresponsible corporate behaviour are often hidden or unrecognised, while the apparent benefits of cutting corners sometimes seem obvious.

It is easy to understand that the respect for the general interest profiles, of safeguarding the environment and of fairness in business – reached through the implementation of TRM – entail costs for the company from which its benefits are only visible in the long run as well as being difficult to measure. The TRM does not directly have an impact on the company's financial

performance, but can mitigate the risk of reputation losses and affect intangible assets (Fonbrun C.J., 1996).
Managers generate *reputation gains* that improve a company's opportunities to attract resources, enhance its performance and build competitive advantage (Fonbrun C.J., Vindova R., 1999).
Reputation determines how stakeholders are likely to behave towards an organization. It can influence investors' decision to hold its shares, consumers' and suppliers' willingness to buy from or sell to it, the extent and nature of media and pressure group attention, potential recruits' eagerness to join it and existing employees' motivation to stay[2].
The interaction between company and stakeholders can increase or reduce its reputation capital and therefore affect the risk of threats and the opportunity platform (fig. 1).

Figure 1: ***Reputation Risk Management Virtuous Cycle***



Adapted from Fombrun, Gardberg, Barnett, 2000

Risks to reputation can arise from many sources, but seven main drivers of reputation are (Rayner J., 2001):
1. *Financial performance*.
The financial results indicate whether the company strategy is competitive and investors are confident that their investments will continue to reap returns.
2. *Corporate governance and quality of management*;
Corporate Governance can be defined as a series of rules, mechanisms and processes generated by the interaction between the different entities on various institutional levels, in order to guarantee the interests of those who operate around and within the company in an equal and satisfactory way, with respect to both the organisation's survival conditions as well as the widespread values generally shared by the original collective (Gatti M, Della Piana B., Testa M., 2005). Displaying good corporate governance is a major contributor to reputation and to market valuation. Obviously an effective corporate governance and a correct interpretation of the relations between its components derive, mainly, from the quality of the leadership.

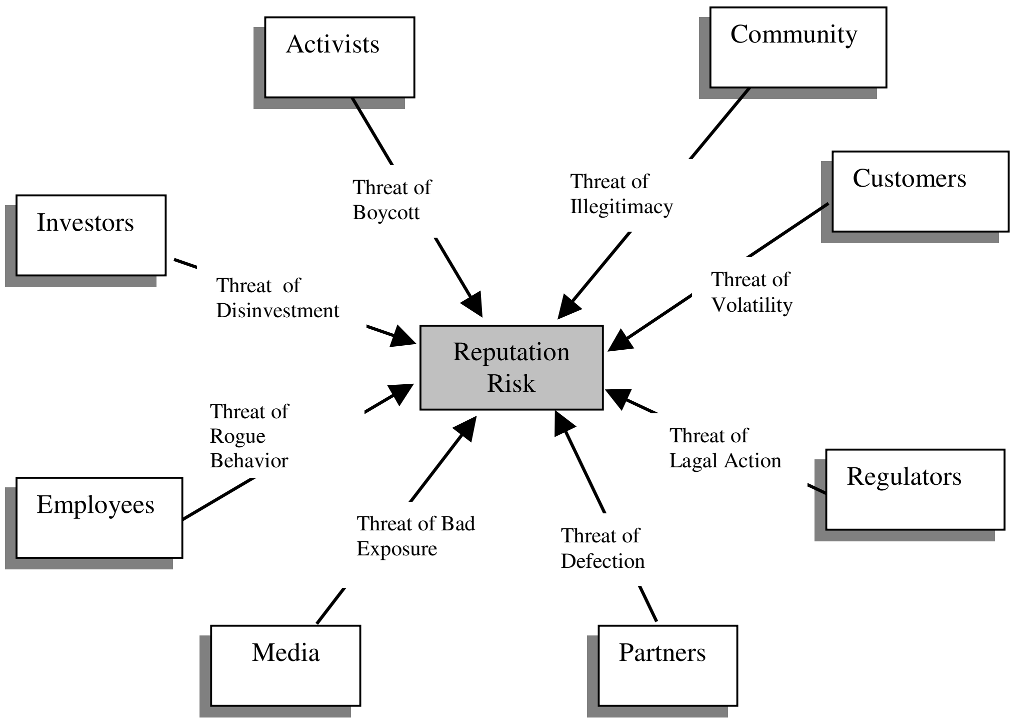
[2] Dr Kim Howells (Minister for Corporate Social Responsibility) has said: "…the best companies, large or small, recognise that the corporate reputation is now a vital element in business success. Companies are exposed to greater public scrutiny, and the information revolution means that the consumers are able to take a much wider range of choices into account when making purchasing decisions". Quoted in the foreword to the Institute of Chartered Accountants of England and Wales (ICAEW) publication "Human Capital and Corporate Reputation: Setting the Boardroom Agenda", June 2000.

3. *Social, ethical and environmental performances*;
Nowadays, the many different types of stakeholder are much more sensitive to social and environmental problems than in the past. Organisations therefore have to try to follow socially orientated aims, ranging from the protection of the environment as well the worker's rights, in order to make the economical rule fit the social one.
4. *Employees and culture*;
Stakeholders' interest in an organization's human capital is leading them to demand information on the kind of people employed in the organization, their diversity, their skills, their training programmes, their motivation and attitude to their employer, their remuneration, staff retention levels and recruiting processes and, *in primis*, the characteristics of the organizational culture.
5. *Marketing, innovation and customer relations*;
Responsibility management involves a process of meetings and dialogues with relevant stakeholders in order to reach agreements on a set of decisions on processes and results. By new processes and innovative goods the companies can obtain their competitive advantage and by customer satisfaction and good faith in all agreements they have the opportunity to maintain it.
6. *Regulatory compliance and litigation*;
Not complying with relevant laws and regulations is one of the main risks for both small and large companies: the violation of the laws or internal corporate regulations can imply serious losses of profit as well as bad consequences for company image.
7. *Communication and crisis management*;
Some organizations are now introducing early warning systems to identify and manage events which may lead to crises, so corrective policies, and pertinent communication actions, can be taken before company reputation is damaged.
All these factors contribute to create reputation capital. This is the fluctuation of company value and can be calculated as the market value of the company in excess of its liquidation value and its intellectual capital (Fombrun, C.J., Gardberg N.A., Barnett M.L., 2000).
Reputation is not only an indicator of past performance, but a future promise and having a good reputation means to have many opportunities and benefits, including (Rayner J., 2001):

- Attracting investors and securing capital at lower cost;
- Attracting customers and creating consumer loyalty;
- Commanding a premium for products and services;
- Recruiting and retaining high quality employees;
- Creating barriers to entry for potential competitors;
- Providing an edge in competitive markets.

Instead, the costs deriving from not having a TRM do not represent the actual monetary outgoings, but can be identified costs from the loss of profits and this therefore justifies the non adoption of responsible choices by any organizations (fig 2).

Figure 2: ***Managing the downside of Reputation Risk and Threats of Costing***



Adapted from Fombrun, Gardberg, Barnett, 2000

It is now generally believed that the social-environmental aspects of the organisation's activity represent factors that are relative to its survival and ability to compete. The actual choice of adopting a TRM will only be possible when the risks from an irresponsible management do not become unbearable for the organisation.

3. Managing Reputation Risk

Managing reputation risk means to consider the current and prospective impacts on earnings deriving from negative public opinion. Obviously, risks cannot be completely eliminated from company activities, but managers have to try to manage the economic and social threats in order to reduce the negative consequences deriving from it.

Reputation Risk Management process is formed by two different but contextual approaches:

- Improving the corporate image by univocal and disclosed behaviors (i.e. strategic options which take the relevant stakeholders and their aims into consideration, sustainability policies, corporate giving, cause related marketing, etc) and through communication;
- Controlling and auditing several company project activities.

Regarding the first point, corporate image refers to how a corporate is perceived. It is generally an accepted image of what a company "stands for". The creation of a corporate image is an exercise in perception management. It is created by institutional and marketing communication, but primarily by what the companies do.

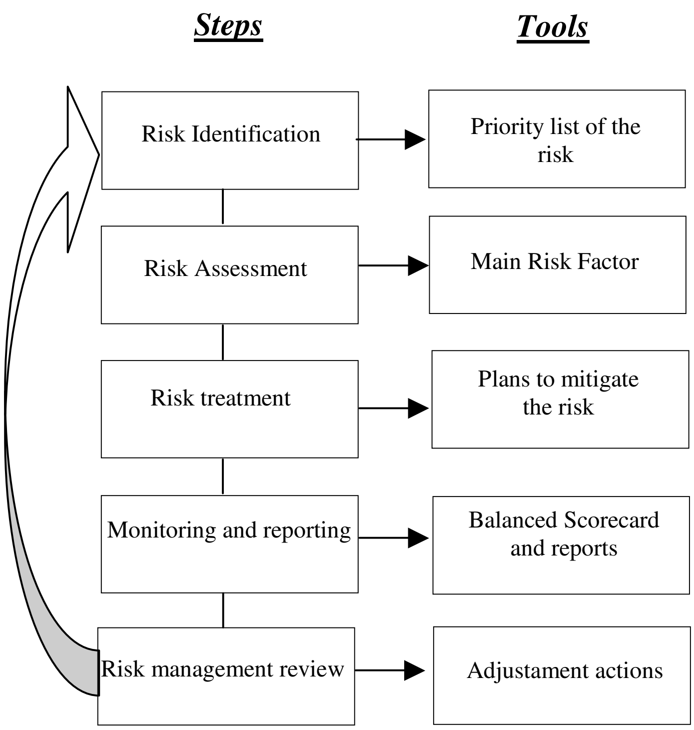
The experience of numerous companies has clearly demonstrated that being inattentive towards company expectations, or moreover betraying corporate image[3], aiming at exclusively communicating the environmentalist, altruistic and philanthropical "façade", generates amplified negative consequences, which hit the organization with growing force.

[3] "(…) per *corporate image* deve intendersi come l'organizzazione viene percepita, in un dato momento, dai pubblici esterni" Siano A., *Comunicazione d'impresa*, Giuffrè, Milano, 2001, 130; besides see.Margulies W.P, "Make the most of your corporate image", in Harvard Business Review, 55, 1977.

The second point is highlighted by the development of *risk culture*. In fact, the management should individualize all company projects and activities that can condition the reputation of the company and manage the possible risks.
Synthetically, the Reputation Risk Management is recognized as an integral part of good management practice, based on an interactive process consisting in the following steps, which, undertaken in sequence, continually improve decision making. The main steps are (fig 3):

- Risk identification
- Risk assessment
- Risk treatment
- Monitoring and reporting
- Risk Management review

Figure 3**: *Steps and tools in Risk Management***



Risk Identification

For each project the manager has to follow a wide array of steps, starting from a systematic analysis of the technologies, production methods, details of the contract, social and environmental effects, etc. This study must group together all the units involved. This can be achieved through discussions, interactive workshops, interviews, questionnaires, brainstorming sessions, etc.
The risk can be identified by a description of the problem and the units involved in the possible effects, creating a Risk Breakdown Structure (RBS), which underlines all the linkages between the risks.
Two different methods can be adopted to build an RBS :

- Top Down – identification of an " aggregated" risk (mask risk) which can be declined into more elementary risks, but due to its "togetherness" nature it cannot be exclusively perceived by the Risk Manager.
- Bottom Up - the risks are denounced to the Risk Manager, by the different functions which participate in programs/projects, in relation to the concrete possibility that an event at risk can manifest itself.

Useful techniques for identifying reputation risk and describing causes, events and consequences, include:

- Upper system analysis (Golinelli G.M., 2005): once conflicts are identified between expectations and delivery capability, the board must decide how to resolve those conflicts - by ensuring that it meets stakeholders expectations, or that it modifies its promises, or by a combination of the two.
- SWOT analysis: the threats can reveal risks to reputation and opportunities can reveal potential levers to enhance reputation.

<u>Risk Assessment</u>

The goal of this phase is to set the risks in order of importance. Reputation risk can be regarded as an impact or consequence of other risks or it can itself be a source of risk. Therefore some organizations manage reputation by scoring the reputation impact of other risks or consider the reputation as a category of risk in itself.

Usually qualitative tools are used and each risk can be measured by helpful techniques:

- PEST analysis, that is an evaluation of the political, economic, social and technological influences;
- Review future regulatory changes;
- Sustainability Balanced Scorecard, that helps to monitor all main risks by integrating them into Key Performance Measures (KPMs) (Metallo G., Cuomo M.T., Testa M., 2004);
- Risk matrix (Likelihood/Consequences).

An estimation of the risk can be achieved by Risk Factor, which derives from the following relation: Likelihood that it will happen x Consequences for the company.

<u>Risk treatment</u>

Risk treatment according to the ISO is the "treatment process of selection and implementation of measures to modify risk [ISO Guide 73]"[4]. Before implementing risk treatments a company has to analyze the possibility and capacity to manage the risk, the costs to eliminate or reduce it and the probable benefits that can derive from it. Considering this, the company can then decide if the risk can be:

- Eliminated or avoided;
- Reduced;
- Transferred to the future or to other units;
- Accepted.

After choosing how to face the risk it necessary to identify the options which could be used to treat the risks, select the best option in terms of its feasibility and cost effectiveness, preparing a risk treatment plan and implementing the risk treatment plan.

<u>Monitoring and reporting</u>

Reputation risk monitoring and reporting provide management and the board with assurance that established controls are functioning properly.

Management should regularly monitor the corporate reputation and the risks from its activity – whether centralized or decentralized at business lines, support functions, affiliates, or business partners – to ensure the vitality of the system and achieving the desired results predicted Effective monitoring and reporting help to inform the management and to identify in advance the future successful processes.

<u>Risk Management Review</u>

This is one of the most important phases, as it analyses the positive or negative results obtained, in order to take the correct and appropriate actions.

These phases will be set and overseen by the Risk Manager, whose task is to guarantee that the system works well, that the risk team is effective, the treatments are appropriate and fast, the

[4] It is only by the active participation of an international organization, as ISO, that a common risk management language for those who are interested in the management of the risk as an integral component of effective corporate governance will be reached.

evaluation report is transmitted. Besides he checks the effectiveness and the costs of corrective actions, suggests strategies to the board and assigns a Risk Owner in case of a high risk factor.

4. Conclusion

In recent times there has been a paradigm shift in many economies, particularly in the way corporate governance, business ethics, risk management and compliance are approached. It is a shift that continues to be driven by demanding performance expectations, increasing stakeholder demands and growing public scrutiny after some spectacular failures around the globe. Potentially, this is a highly positive development. An investment to reduce the risk places a premium on solid performing businesses that are well-managed, conferring a competitive advantage on businesses that create and maintain a culture of “integrity-driven performance”.

Currently, a good strategy is not effective if the corporate has a bad image. Today, reputation is one of the most important corporate assets and it is also one of the most difficult to protect.

The measurement of the reputation level, which is at the base of the pertinent social consent, has to permeate *ex ante* ideation and evaluation of the strategic options.

Adopting strategic decisions is the combined effect of managerial processes and socio-cultural influences that are placed inside and outside the entrepreneurial organization, between numerous systems that have diverging interests.

With regards this, it is interesting to highlight that even in an analytical-formal approach, based on addressed and guided instruments, often the fundamental decisions and strategic options appear modeled by experience, cognitive processes, and the ability to recognize and interpret timely marks of change from the outside as well as from those inclined towards recognizing the risk.

So, only the enlightened managers that take care of reputation risk will obtain a positive corporate image, transforming the threats in opportunities and the costs in probable gains .But before identifying a risk system, it is necessary that a culture in all the entrepreneurs oriented to the Corporate Reputation exists, as well having managers communicating their own philanthropic activities.

The behaviors based on the adoption of own business cultural values and a clear vision of the purposes of the enterprise, engrave a strong coherence to the actions undertaken in the course of time orienting the direction of future conduct. From this point of view reputation represents a promise of reliability.

This new awareness should contribute to improve not only the control processes but the ideation and implementation phases, in order to consciously plan and achieve business goals, improve performance, satisfy stakeholders, increase effective exploitation of new opportunities and good corporate governance.

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