Understanding reputational risk
The costs of ‘act now, worry later’

This paper summarises key findings from the discussions at the Malaysian Institute of Integrity and Chartered Institute of Management Accountants roundtable on reputational risk, based on a global CGMA survey. The roundtable focused on the growing attention to risk, the role of social media and the benefits of safeguarding reputation. The resultant recommendations aim to help individuals and organisations to both reflect on their practices and consider how best they can strengthen integrity in their business.

Discussion paper – January 2014
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representatives also drew on their experiences of working with companies across Malaysia and internationally.

The summaries of these discussions represent the personal views of participants and cases cited in the roundtable are not
the views of companies or countries as a whole. The discussions are intended to equip the reader with increased knowledge
of current ethical issues locally faced in business and as such do not provide a quantitative evaluation of opinion. Neither the
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DISCUSSION PAPER
Understanding reputational risk
The costs of 'act now, worry later'

Findings from the Malaysian Institute of Integrity (IIM) and the Chartered Institute of Management Accountants (CIMA) roundtable on reputational risk.

January 2014
About IIM

The Malaysian Institute of Integrity (IIM) is the brainchild of the 5th Prime Minister of Malaysia, Tun Abdullah Haji Ahmad Badawi, declared on 5 November 2003. It was established as a company limited by guarantee under the Companies Act 1965 on 4 March 2004. The IIM was established as a coordinating agency for the implementation of the National Integrity Plan (NIP). The main objective of IIM is to develop a nation of high integrity that is resilient and embraces universal good values. The IIM works on the basis of strategic alliance and smart partnership with organizations in order to promote a culture of ethics, good governance and corporate integrity.

About CIMA

The Chartered Institute of Management Accountants, founded in 1919, is the world’s leading and largest professional body of Management Accountants, with over 218,000 members and students in 177 countries. CIMA works closely with employers, sponsors leading-edge research and constantly updates its qualification to ensure it remains the employers’ choice when recruiting financially-trained business leaders.

Professionalism and ethics are at the core of CIMA’s activities with every member and student bound by robust standards so that integrity, expertise and vision are brought together.

CIMA has formed a joint venture with the American Institute of CPAs (AICPA) to establish the Chartered Global Management Accountant (CGMA) designation. CGMA is the global quality standard that further elevates the profession of management accounting.
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INTRODUCTION

Reputational risks involved with unethical behaviour are receiving increasing attention by financial leaders globally. A damaged reputation takes a long time to restore, and could impact not only on the individuals involved but also on the wider organisation and stakeholders.

According to a global survey in August 2013 of over 1,500 finance leaders who hold the Chartered Global Management Accountant (CGMA) designation, companies are beginning to put reputation before profit. The survey identified three main reasons for the increased global interest on reputational risk - the demand for greater transparency, incidents at leading organisations or competitors that led to a loss of reputation and the rise of social media.

The survey showed that:

- Three quarters (76%) of global financial leaders said their company was prepared to lose profit in the short term for the sake of protecting its long-term reputation (SE Asia: 80%)
- The same number (76%) placed more focus on reputational risk today than in previous years (SE Asia 79%)
- Almost half (44%) had rejected a project that made financial sense because the reputational risk was too great (SE Asia 49%)
- Nearly 1 in 4 (22%) organisations had experienced a reputational failure (SE Asia: 21%)

Once the sole remit of the marketing and PR departments, reputational risk is now seen as a critical company-wide concern. Despite this, over 95% of organisations surveyed admitted to not always using feedback from social media channels to help them anticipate and manage risk to their reputation. Similarly, 62% of those surveyed had no formal processes or models in place for calculating the financial impact of not managing reputational risk.

CIMA and the Malaysian Institute of Integrity (IIM) organised a roundtable on reputational risk on 28 November 2013 to better understand the reputational risk scenario particularly in Malaysia. This roundtable adds on to the several activities on ethics that have been initiated by CIMA and IIM under the Corporate Integrity Pledge (CIP) signed by CIMA in 2012 and also the Memorandum of Understanding (MoU) between CIMA and IIM that was signed in the same year.

The roundtable brought together representatives from various companies – SMEs, multinationals and the regulators – to discuss whether Malaysian businesses are putting more focus on reputational risk than before, the effect of social media and the benefits of safeguarding reputation.
Do you think businesses in your industry are putting more focus on reputational risk today than they did in the past?

Base: 1,368

- Somewhat less: 2%
- About the same: 22%
- Somewhat more: 45%
- Significantly more: 31%
- Significantly less: 0%

What do you think are the primary factors behind the increased global focus on reputational risk?

<table>
<thead>
<tr>
<th>Ranking SE Asia</th>
<th>Overall Global rank</th>
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</thead>
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<td>Reputational failure at a leading organisation / our competitor</td>
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<td>Market demand for more transparency</td>
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<td>The rise in social media (e.g. Facebook, Twitter, LinkedIn)</td>
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<td>Internal pressure – i.e. employee values</td>
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</tbody>
</table>

Total respondents: 109 from Malaysia, Australia and Singapore
1 Is there an increase in focus on reputation in Malaysian businesses?

Despite the survey results, there was a mixed response from the roundtable as to whether there is now more focus on reputational risk than five years ago. Depending on the industry and size of the organisation, whether multinationals or SMEs, each faced different types of pressures. For companies that have faced a reputational failure before, addressing risk is a priority, and they are more prepared to lose short term profit for the sake of safeguarding their reputation for longer term success.

A growing number of larger corporate and multinationals have recognised the impact of reputational damage, particularly in relationship to supply chain, investment relations, customer retention and outward investment. But not all are truly highlighting such risk. For SMEs, addressing issues of reputation can sometimes be challenging as they are often more focused on day to day business survival, without considering longer term fallout.

There is increasing evidence that values based organisations that have good governance, good employee relations and good environmental awareness, tend to attract skilled talent and are more successful in the long term than their competitors. The importance of understanding and safeguarding the intangible aspects of the business is now essential. "The need for a broader information set is clearly demonstrated by the small percentage of market value now explained by physical and financial assets – down to only 19% in 2009 from 83% in 1975. The remainder represents intangible factors, some of which are explained within financial statements, but many of which are not" IIRC Discussion Paper, 2011. These intangibles include aspects such as human, social, environmental and intellectual capital. The value attached to such capitals can be impacted greatly by shortcomings in the company’s activities, such as corruption, health and safety, defective goods, labour unrest, environmental damage and the consequent reputational hit will be well beyond the short term financial loss.

Members of the roundtable believed that the value system has to begin from the CEO and it is incumbent upon the CEO to drive down the value system to the employees in the company. As such, the CEO must have the qualities of a Chief Integrity Officer. The CEO must be the role model for ethical behaviour and communicate the value system to the employees by using simple language that is easily understood (e.g. ‘corporate governance’ is a big word that needs to be simplified and explained).

One of the roundtable participants said that value system is important not only for entrepreneurs but law makers and enforcement officers as well. Only then will there be progress in tackling corruption and unethical practices.

Regulators such as Bursa Malaysia and the Companies Commission of Malaysia are currently creating more awareness of corporate governance and reputational risk through organising training courses for companies. Any irregularities in companies are investigated by the Companies Commission of Malaysia in co-operation with the Malaysian Anti-Corruption Commission and the Royal Malaysia Police. Globally, institutional investors and stock markets are paying more attention to issues of reputation than ever before because nothing has a bigger hit on stock market prices than reputational scandals.

For some companies at the roundtable, it was felt that reputation was being managed only at a higher level and information is not driven down to the employees. There are statements and polices but these do not reach the employees. Increasingly large corporates operating in multiple geographies are recognising the risks and placing attention on communicating and embedding good corporate practice. Siemens have global initiatives where they are addressing the gap between top management and lower level employees through middle management to encourage a strong values-based culture.

A member of the roundtable commented that generally, Malaysian businesses do realise the effects of reputational risks, particularly large multinationals, government linked companies and local conglomerates. However small and medium enterprises (SMEs) that make up more than 90% of businesses in Malaysia are not concerned about reputation but rather on the survival of the company. At some point however, small companies will have to focus on their reputation particularly if they are part of a supply chain that supplies to big companies.

Interestingly a case study by an established local university in Malaysia showed that family businesses tend to place more emphasis on values which are often founded on religious beliefs and principles. These values have helped to build up the brand and it is the values that drive reputation that in turn result in profits. Often these values are built up over a long period of time. This shows the potential and benefits for smaller privately owned companies in investing and safeguarding their reputation.

Customer facing companies are usually more prone to reputational risk but other companies should not be complacent in this respect. ‘Act now, worry later’ seem to be prevalent among companies in Malaysia and the worry is that they might have to take some of the bitter medicine of a scandal to have a wake-up call and be on the road to changes, as seen in the US and Europe. Regulators can have all the rules and regulations but if companies are able to just check the box and there is no strong audit, or true culture to speak up and address issues, the repercussions can be tremendous.

Case study on family businesses

We have researched several successful and large family businesses in Malaysia. Family businesses are unique compared to other organisations because of family dynamics that can influence ownership, governance and business domains of the organisation. One of the key findings in our study was that family values played an important role in developing organisational capabilities and corporate identities which would reflect on the image and reputation of the organisation. These family values are founded on religious beliefs and principles. This finding may challenge the Porter-Kramer model of business ethics that corporate social responsibility is driven by profit and strategic motives. On the other hand, an organisation, particularly a family business which inculcates the culture of family values, conducts social initiatives based on virtues that are rooted on religious beliefs and principles.

Research by Professor Mohar Yusof of UniRazak on ‘Family Values: Building Organizational Capabilities and Corporate Identities’ as part of a global research project called ‘Successful Transgenerational Entrepreneurship Practices (STEP)’. Further info about the project, http://www.babson.edu/Academics/centers/blank-center/global-research/step/Pages/home.aspx
Case study from Siemens

One can learn from best practices at Siemens where they are currently focusing on bridging the communication gap between top management and the lower level employees through the middle management. They have implemented ‘integrity dialogues’ where their business leaders and top management speak on integrity and ‘walk the talk’ in terms of doing business. These integrity dialogues are also built into every sales meeting, to bring about an open discussion on ethical issues from the floor and ways of handling these issues. Siemens is also doing a lot more with its managers today such as having more training, more coaching and better communication structures. It is also focusing on getting the right people with the right values to manage the business i.e., having good qualifications is not the only criteria. Through its ‘Tell Us’ portal, employees and stakeholders are able to lodge any compliance-related concerns they may have. The Siemens Compliance Organization is independent and has a direct reporting representation to the Board of Siemens AG.

What is the effect of social media?

Increasingly online scrutiny and exposure pose the greatest challenges for effectively managing a company’s reputation. Customers, employees, advocacy groups and the wider general public now have multiple platforms to voice their views or concerns. Instant communication via social media (Facebook, Twitter, etc.) and a host of online channels have cast a harsher spotlight than before.

CGMA research showed that assessing the impact of potential reputational damage is hard to do. Despite the majority of respondents stating their company was prepared to lose profit in the short term for the sake of protecting its long-term reputation, the majority of organisations admitted to not always using feedback from online channels to help them anticipate and manage risk to their reputation. And this is despite social media being one of the key factors that heightened reputational risk. What was striking in the findings was that nearly a quarter of respondents worked for organisations that had experienced a reputational failure at 22%, no doubt as companies can no longer easily hide information and their reputation is often outside the control of the PR team.

With the market demand for transparency listed as the main factor for increasing focus on reputational risk, together with the fear inspired by reputational failure at a leading organisation or competitor coming in second, those working in finance are well advised to truly consider benefits for the longer term against short-term wins that lack integrity.

A good example brought up by the roundtable on the effect of social media was the KFC scandal in February 2012 where a fight erupted between a customer and the staff of KFC at an outlet in Malaysia. A witness to the incident uploaded a video of the fight on YouTube which went viral and prompted an uproar that saw social media users taking sides between the customer and KFC. Not only was the incident shown on YouTube, it was also discussed on Facebook and online news portals quickly picked up the story. The discussions on social media soon spiralled into allegations of racism which could have had an unfortunate outcome if not for the prompt actions taken by KFC to resolve the problem.
The impact of social media on reputation can be huge as one company at the roundtable found out. An unhappy customer created a blog to voice his unhappy experience and this blog became viral and the news spread very quickly. The company not only had to spend a lot of time and effort in repairing the damage but the additional downside was the huge emotional impact on its staff morale. On the positive side, the company used social media to promote an event where participation doubled that of its expectations. This company also uses Facebook to engage with its employees and stakeholders where messages are simplified in the language of Gen-Y to educate them on reputational risk. It was mentioned that there are many programmes on integrity and ethics but often these reach the head only and not the heart. When it reaches the head, it is not sustainable because people tend to forget but when it reaches the heart, it is a breakthrough because it is about that person being a human being who is caring and ethical.

With the speed of social media and its possible repercussions during a scandal, only a minority at the roundtable uses social media to anticipate and manage reputation risk, reflecting the global findings. Although customers and employees have been identified as key influencers over reputation, understanding and engaging with social media should be even higher.

The power of social media should not be underestimated – it can be a double edge sword, as mentioned by the roundtable, spreading good news just as fast as bad news. However its impact is very much industry related. In the construction industry, its impact is only felt when a disaster happens. Customer facing companies are more susceptible and as social and online media will only increase in impact, companies need to consider their strategies to both harness and engage with it.

3 Benefits of safeguarding reputation

If companies are simply putting an onus on survival as in the SMEs, then the benefits for the long term are not understood well enough. There seems to be more short termism, perhaps reflecting the speed of development in Malaysia in the last decade.

Companies in Malaysia should not be complacent on reputational risks. As Warren Buffett once said, ‘it takes twenty years to build a reputation, and five minutes to destroy it. If you think about that, you'll do things differently.’

George Serafeim writing for the Harvard Business School found, in his paper Firm Competitiveness and Detection of Bribery, that ‘bribery’s most significant impact is its negative effect on employee morale’. Whilst senior executives need to consider the impact on reputation of a scandal and the related regulatory fines (which are ever more punitive) they would be advised to also be calculating the loss of productivity, talent and engagement as well as the impact on partners and customers. Negative impact on reputation has numerous effects which can take years to undo.

As Serafeim in his research concluded, ‘The lesson for managers is that bribery is more costly than you might think. If you think of the cost as just fines and regulatory actions, you’re missing a big piece of the puzzle.’

The value of a good reputation should not be underestimated. Firms with strong, positive reputations can attract and retain crucial talent and often have loyal customers that are likely to buy a broader range of products and services. It can lead to higher sales generated by satisfied customers and their referrals, and has the potential
to raise capital and share price. Also, in an age of regulatory watchdogs, a positive reputation can improve relationships with government officials and regulators. It will also create a benefit of doubt by stakeholders if a crisis strikes.

The benefit of safeguarding reputation is ultimately for the long term sustainability of the company. Appropriate collection, reporting and monitoring of reputational risk information will enable corporate leaders to performance manage this important aspect of their business. It makes more sense to mitigate the risks in the first place and ensure that business is run soundly for the long term.

RECOMMENDATIONS

Clearly, members of the roundtable recognise the importance of a good reputation for companies. While a good reputation can lead to a boon of benefits, a bad reputation, conversely, can lead to a loss of customers, disengaged and unmotivated employees and shareholder dissatisfaction.

The following recommendations would help an organisation build a strong and open culture in order to prevent reputational failures:

1. **Be transparent and do the right thing in the first place**

   Companies should be doing the right thing in the first place to earn the benefit of the doubt when a crisis strikes and provide them with a softer landing should they face a situation which threatens their reputation. Reputation is not something that can be insured against, so self-insurance and trust from wider society is the key. This should cover not only ethical aspects related to financial propriety but also operational issues and risks such as health and safety, product risk or data management.

   In the CGMA survey, the number one factor identified as prioritising reputational risk was seen as the rise in demand for transparency. To this end, all companies, wherever they operate and whatever their size, are advised to increase focus on the long term, minimising risk and maximising opportunity. Ultimately transparency counters a ticking time bomb. Remember someone internally knows something is wrong. Do you?

2. **Monitor and act on relevant information and data**

   As 62% of those surveyed had no formal processes in place for calculating the financial impact of reputational risks, finance directors and leaders need to better understand potential causes and fall out of failures. Social media has been highlighted as a key area to address in order to manage online reputation and engagement. Companies need to regularly monitor social media for what is being said about them, their competitors and industry. Other areas of the business related to whistleblowing lines, patterns of financial transactions, supply chain due diligence and relevant HR insights, such as grievances or performance issues, are all areas that should be reviewed for 'red flags'. There is often a requirement to increase the quality and use of non-financial information and internal reporting data. Critically any areas of concern should be dealt with quickly with relevant leadership support.
3. **Communication with employees is the key**

Reputation management should always begin and end with every employee, from the CEO’s office to the mail room. It is a collective responsibility. As a matter of fact, the strength of a company in managing its reputation is only as strong as its weakest link. All it takes is one person’s error and the company’s reputation could be severely damaged. Communicate regularly with your employees and educate them on the risks of reputational failure and the benefits of safeguarding reputation, developing and providing the relevant processes and tools to support them.

4. **Role of the Chairman and Non-Executive Directors**

Boards, particularly the Chairman and Non-Executive Directors (NED), need to recognise the importance of risks that are not captured by current approaches – they also need to focus on how to ensure missing risks are captured.

There is also a need for more sophisticated NED and executive education directed towards the understanding of, evaluation of and engagement with risk. This needs to go far beyond risk analysis and aversion, to bring risk and risk appetite routinely into board discussions about risks, opportunities and reward.

5. **Role of risk professionals**

The role and status of risk professionals will have to change so that they can safely evaluate report and discuss all they find on underlying risks at all levels, including at board level.

Risk professionals may need to extend their skills so that they become competent to identify, analyse and discuss risks emerging from the ethos, culture and strategy of their company and the activities and behaviour of their leaders.

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Acting under pressure – how management accountants manage ethical issues, CIMA, 2012

CGMA reputational risk pulse survey, CIMA, 2013

Firm Competitiveness and Detection of Bribery, Serafeim, George, Harvard Business School, 2013


Collective Action Information and resources:

Siemens Integrity Initiative

IIM’s range of resources
http://www.iim.org.my
http://cism.my
http://www.pemandu.gov.my
http://www.sprm.gov.my

CIMA has a range of resources on ethics and responsible business at www.cimaglobal.com/ethics.