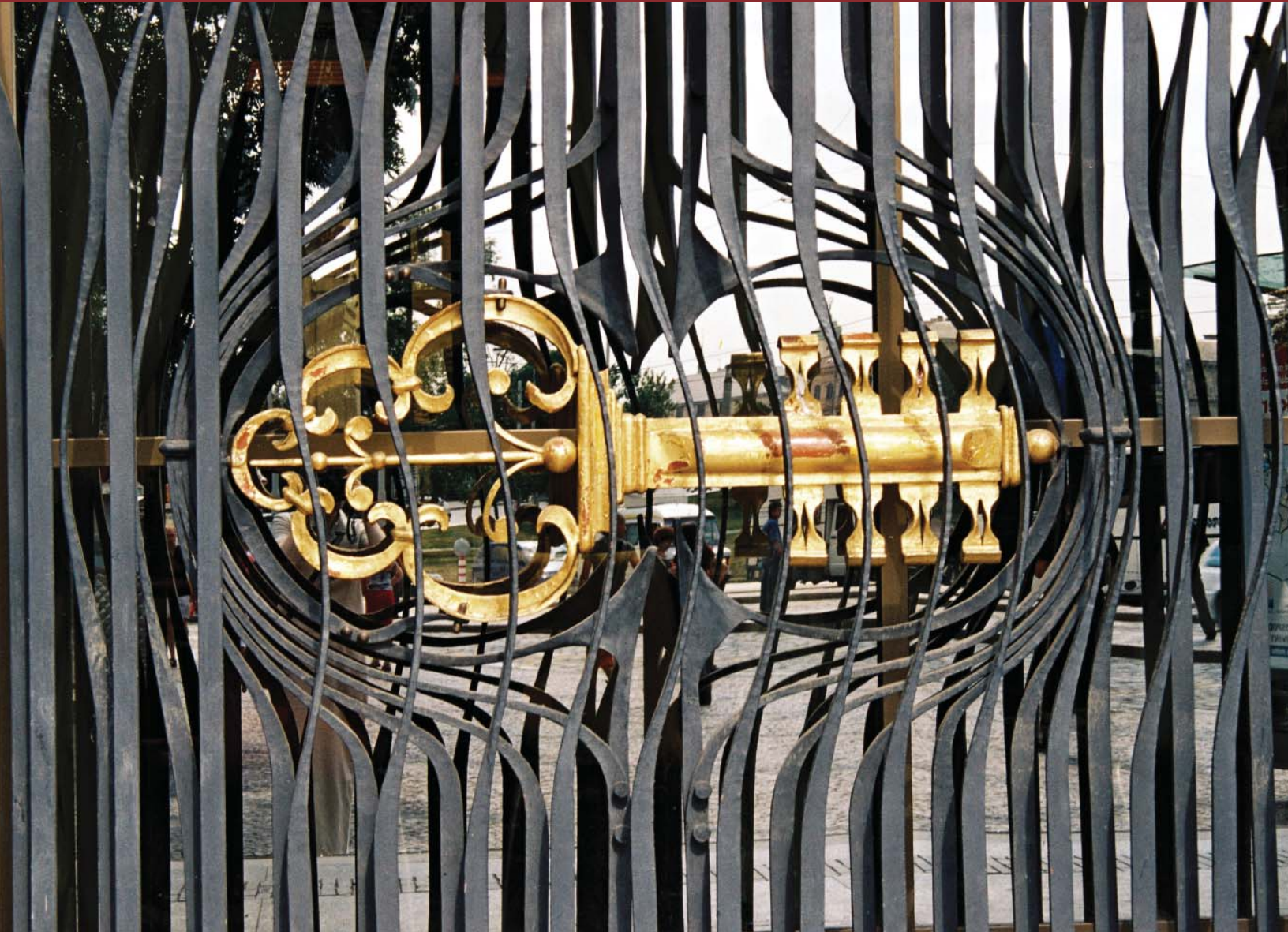


Predicting the unpredictable:
Protecting retail & consumer
companies against reputation risk*



*connectedthinking

PRICEWATERHOUSECOOPERS 

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Why reputation?

“A good reputation is more valuable than money.”

Publius Syrus, Maxim 108 (42 B.C.)

What is a consumer company’s greatest asset? Ask that question of any CEO, analyst, employee, customer or supplier and the likely answer will be — “Reputation.” Ask those same stakeholders to name the company’s greatest risk, and the answer remains the same — “Reputation.” To quote Warren Buffet, “It takes 20 years to build a reputation and five minutes to ruin it.”

Consumer products manufacturers, retailers, and others along the supply chain (collectively “Retail and Consumer” companies) are more prone to reputation risk today than ever before. Globalization has created challenges with an attendant need to manage far-flung operations that embrace new business models and distinct cultural values in emerging markets. The flattening of hierarchal organizations across many corporations has resulted in the placement of less experienced managers in positions to face ethical issues never previously envisioned at such an early stage in their careers. And the loss of employee loyalty, owing to outsourcing, the emphasis on productivity, and corporate streamlining has resulted in less personal ownership of ethical issues by employees. These marketplace realities are compounded by the increased pressure on companies to meet capital market expectations. A focused enterprise-wide program dedicated to identifying and mitigating corporate risks to reputation, along with rewarding good behavior, can effectively help corporations protect their reputations.

Prior to the most recent corporate reputation scandals, risks to reputation were generally centered on the broad categories of product safety, environmental impacts, and employment violations.¹ According to a PricewaterhouseCoopers (PwC) survey, consumers hold companies responsible for bribery, child labor violations, discrimination, worker health and safety, and harming the environment.² These risks are all very real and



applicable today. However, there is now a new category of risks to reputation that deserves attention — the risks to a company’s reputation resulting from lack of strong corporate governance and/or the misconduct of corporate executives – even if only in their personal lives. The current environment needs very little to create corporate scandal. Yesterday’s water cooler gossip can become today’s front page news. What was once an industry-wide practice can become tomorrow’s industry-wide criminal investigation, as recently demonstrated by the issues

¹ D. Neef, *Managing Corporate Reputation & Risk* 42 (2003)(Neef)

² *Id.* at 63; PwC, *Survey Finds Many Consumers Hold Companies Responsible for their Actions* (1999)

raised by channel stuffing events associated with industry trade loading practices.

Retail and Consumer companies must be particularly vigilant in protecting their brands and reputation. Those companies devote enormous resources and expend valuable marketing dollars building their brands and developing reputation equity with their customers and other stakeholders – and these reputations are not built overnight.

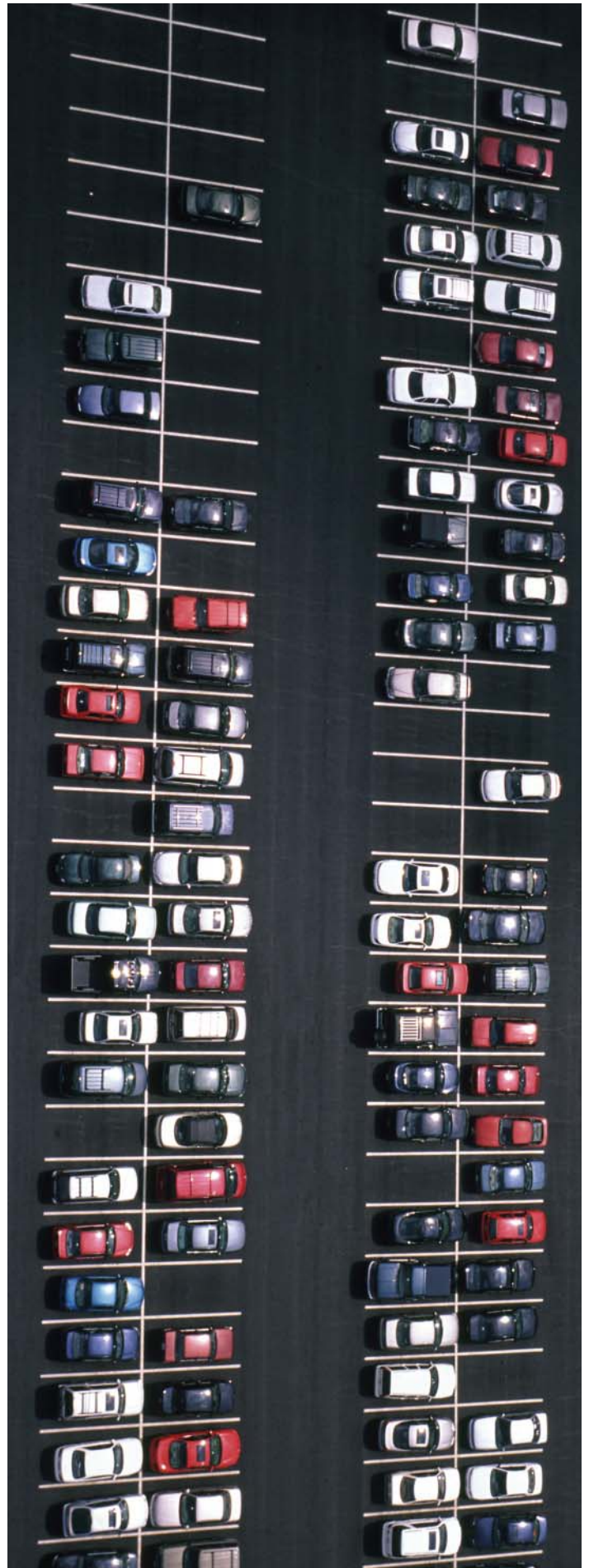
Easily influenced, consumers can be extremely quick to avoid a company's products and services if an incident causes them to lose trust in the "brand," while the financial markets can likewise react very quickly upon hearing any news detrimental to a company's reputation.

Despite the importance of their companies' reputations, relatively few Retail and Consumer companies have a comprehensive framework, approach, and infrastructure in place to identify and manage reputation risks, including evaluating related controls, and allow them to respond quickly and effectively if a damaging event were to occur. Without such a plan, Retail and Consumer companies are exposed to ever-expanding business land mines and booby traps, capable of destroying even the most pristine of corporate reputations.

Efforts to develop a plan are often hampered by a triple challenge:

1. Gaining internal consensus on the definition of what constitutes reputation risk,
2. Creating a risk management framework capable of supporting the proactive identification, measurement, and management of reputation risk, and
3. Integrating proactive reputation risk management with other ongoing initiatives and requirements (e.g., corporate governance, the Sarbanes-Oxley Act of 2002 (Sarbanes), etc.).

This whitepaper offers Retail and Consumer companies a practical plan for responding to these challenges and building a program to effectively manage and mitigate reputation risk. This includes avoiding disaster and, more generally, the process by which Retail and Consumer companies assess and protect against devaluation of their image and reputation among various stakeholders. The paper builds upon work already required by Sarbanes, particularly regarding antifraud programs and controls, and expands upon the recently issued Enterprise Risk Management – Integrated Framework of the Committee of Sponsoring Organizations ("COSO") of the Treadway Commission. This whitepaper also explores the challenge of defining "reputation" when there are multiple stakeholders, measuring the value of reputation in financial terms, and identifying key reputation risks faced by Retail and Consumer companies.



Reputation rests in the eye of the beholder

“To gain a good reputation is to endeavor to be what you desire to appear.”

Socrates (469 BC - 399 BC)

Like beauty, reputation rests in the eye of the beholder, or for Retail and Consumer companies, their many stakeholders — i.e., customers (current and future), employees, suppliers and alliance partners, investors, and the general community or society, etc.³ Reputation, moreover, encompasses many variables and reflects the leadership, core values, culture, integrity, social responsibility and the track record over time, of a company. Each stakeholder has its own set of measures and expectations against which a company’s behavior is judged.

In 2003, PwC, together with several major financial institutions, formed the Reputation Trust to study and improve the management of corporate reputation and risk.⁴ The study identified five key stakeholder groups with an interest in corporate reputation: customers, employees, suppliers and partners, investors, and community or general society. The study confirmed that each stakeholder group has varying interests, concerns, and expectations, some of which are described in Table 1.

Balancing a company’s actions in response to the interests of these varying stakeholder groups is difficult, but must be a key consideration in developing a plan for managing reputation risk.

The definitional challenge is company-specific. External groups (e.g., regulators and standard setting bodies) have put forth definitions of “reputation risk,” but companies need a common definition internally to effectively manage reputation risks and communicate effectively with key

Table 1

Stakeholder Group	Examples of Expectations
Customers	<ul style="list-style-type: none">• Trust/respect/admiration• Service/fair treatment• Product quality/value• Convenience/accessibility
Employees	<ul style="list-style-type: none">• Corporate culture• Workplace environment/safety• Fair treatment• Opportunity
Suppliers and Alliance Partners	<ul style="list-style-type: none">• Volume of business• Management/operations• Financial stability
Investors	<ul style="list-style-type: none">• Investment/financial performance• Corporate governance• Regulatory compliance
Community/Society	<ul style="list-style-type: none">• Community involvement• Contribution to tax base• Respect for environment• Fair treatment of people

stakeholders. Key questions to consider are:

- What are perceived to be the core reputation issues the company faces?
- What are the root causes or underlying sources of risk events?
- Within the company’s risk management framework, how do these root causes relate to other risk categories?

³ R. Alsop, The 18 Immutable Laws of Corporate Reputation (2004) (“Alsop”); G. Dowling, Creating Corporate Reputations 30 (2001)(Dowling)

⁴ Reputation Trust, Managing Stakeholder Expectations of Risk and Return (March 2003), available from PwC’s Retail & Consumer industry website at www.pwc.com/retail

Answers to these questions vary by stakeholder group. Each group has its own expectations and it is through interactions with them that companies accumulate or destroy reputation equity. That equity (or reputation capital) is built up when companies are “firing on all cylinders...to tide them over in turbulent times.”⁵ Varying sensitivities of different stakeholders to individual risk events, the company’s perceived reaction and/or ability to appropriately respond, and subsequent adverse events during a given timeframe can affect reputation equity built up with each stakeholder – and can change continuously. The Appendix compares risk attributes against their relative importance to varying stakeholder groups.

The governance challenge is to assess continually each key stakeholder, understand how their key concerns and expectations impact reputation equity, and implement an organizational model that effectively mitigates reputation risk and preserves and enhances reputation capital. This includes not only assessing stakeholder concerns and changing corporate behaviors to meet those expectations, but also reporting how well the company is living up to those expectations.

How do retail and consumer companies stack up?

Are Retail and Consumer companies satisfying their stakeholders’ concerns? There are a number of popular studies and surveys published each year that address issues surrounding reputation and respect, stacking companies up against one another on a rating scale. The studies measure various attributes such as emotional appeal, products and services, vision and leadership, workplace environment, financial performance, social responsibility, etc. (see Table 2). Retail and Consumer companies had a presence in most surveys observed, but were not a dominant winner in any.

The significant takeaway from these studies and other similar studies⁶ is that reputation means different things to different people and it is being measured in different ways. It is important, therefore, in defining “corporate reputation,” that companies consider both their attributes and stakeholder concerns as critical elements in developing a plan for managing reputation risk.

Table 2: Example surveys addressing reputation and respect

PwC and Financial Times annual survey

In an annual Survey of the World’s Most Respected Companies jointly sponsored by PwC and the Financial Times, criteria including shareholder value, corporate social responsibility, integrity, and governance were weighed through interviews with 1,000 CEOs across 20 countries. Retail and Consumer companies did not score highly in this study, comprising only three out of the top 50 spots.

Reputation Institute RQ Ratings

The Reputation Institute, a think-tank originally founded under the joint sponsorship of PwC and Shandwick International, annually publishes the results of the Reputation Institute’s RQ Ratings, based on the Harris-Fombrun Reputation Quotient (RQ). The survey measures corporate reputation as perceived by consumers, investors, and employees. RQ ratings evaluate stakeholder perceptions across 20 attributes, which are grouped into six dimensions of reputation: products and services, financial performance, workplace environment, social responsibility, vision and leadership, and emotional appeal. Placing third in the top ten, Retail and Consumer companies fared better in this study than the PwC/Financial Times studies.

Fortune Magazine survey

Fortune Magazine likewise publishes an annual survey of most admired companies.⁷ Its 2005 survey is based on eight attributes, including innovation, social responsibility, employee talent, management, investment value, use of assets, financial soundness, and products and services. In this survey, the top ten included two Retail and Consumer companies, and the top 50 included 13 Retail and Consumer companies.

Delahaye Index

The Delahaye Index studies the strengths and weaknesses of America’s 100 largest companies. Based on the year’s news coverage, the Index considers five key drivers of corporate reputation, including stakeholder relations, financial management, products and services, organizational integrity, and organizational strength.⁸ Only one Retail and Consumer company placed in the top ten in this study.

⁵ Alsop at 17

⁶ For a description of other studies, see J. Larkin, Strategic Reputation Risk Management 28 (2003)(Larkin); see also Alsop at 32

⁷ A copy of the full list of the 582 companies and 8 criteria is available from PwC’s Retail & Consumer industry website at www.pwc.com/retail

⁸ Results are available from PwC’s Retail & Consumer industry website at www.pwc.com/retail

Does ‘reputation’ have a financial value?

“Regard your good name as the richest jewel you can possibly be possessed of — for credit is like fire; when once you have kindled it you may easily preserve it, but if you once extinguish it, you will find it an arduous task to rekindle it again.”

Socrates (469 BC - 399 BC)

Studies demonstrate that corporate reputation, while it may not explicitly appear on the balance sheet, is a valuable asset. PwC’s 2004 CEO survey conducted in association with the World Economic Forum reflects just how seriously reputation risk is perceived among company executives.⁹ Some experts even contend that reputation is THE most valuable asset a company has.¹⁰

A strong reputation has both operational value and financial value. Generally speaking, most would agree that a good corporate reputation attracts customers, investors, and talented employees, leading to higher profits.¹¹ In some instances, customers are even willing to pay a premium to do business with companies that have a positive reputation for product and service quality.¹² A good reputation can also result in a higher credit rating, making it easier – and cheaper – to tap capital markets.¹³

A strong reputation not only helps a company attain stronger earnings, but it also helps to sustain profitable growth.¹⁴ In one study, an Australian business school professor compared the after-tax return on total assets (ROA) of companies listed over an eleven-year period in Fortune’s “Most Admired Companies.” The study determined that:

- (1) “Good corporate reputations increase the length of time that firms spend earning superior financial returns (carry-over effect), and
- (2) good corporate reputations may reduce the length of time that firms spend earning below-average financial returns (a lead-indicator effect).”¹⁵

Measuring short- and long-term reputation capital provides a simple way of quantifying the dollar value of a company’s reputation.¹⁶ A useful working definition of reputation capital is “the amount by which the company’s market value exceeds the liquidation value of its assets.”¹⁷ Reputation capital has separately been described as a “savings account for a rainy day”¹⁸ or a “life preserver in a crisis and a tailwind when you have an opportunity.”¹⁹ Others measure reputation capital using a company’s market capitalization. Short-term reputation capital may be calculated on the basis of its current market value, and thus fluctuates with the price of company shares.²⁰ Long-term reputation capital may be calculated on the basis of its average market value and book value over many years.²¹

⁹ PricewaterhouseCoopers, 7th Annual Global CEO Survey (2004), available from PwC’s Retail & Consumer industry website at www.pwc.com/retail

¹⁰ See, generally, Alsop.

¹¹ Alsop at 10; Dowling at 14

¹² Alsop at 10; Dowling at 12

¹³ Id at 15 -16

¹⁴ Dowling at 14

¹⁵ Dowling at 16

¹⁶ C. Fibrin, Reputation: Realizing Value from the Corporate Image 92 (1996) (Fibrin)

¹⁷ Id. at 92

¹⁸ Alsop at 17

¹⁹ Id. at 17 (quoting Bill Margaritas of Federal Express)

²⁰ Fombrun at 98

²¹ Id. For a listing of the Retail & Consumer companies, see id at 99.

The value of brands

Today, brands and other intangible assets represent a significant proportion of a company's enterprise value. PwC research indicates that intangible assets may represent over 60% of a company's market value. For many Retail and Consumer companies, that value relates primarily to a company's brand(s). Acquirers pay multiples over book value for consumer branded businesses because of their strong reputations and brand value. Brand value can be seriously undermined with damage to corporate reputation.

In financial terms, brand value generally is defined as the present value of expected future earnings or cash flows accruing as a result of brand ownership. Techniques for calculating this value, and the drivers that influence it, are attracting increasing interest and debate around the world. Techniques cover a multitude of value drivers: for example, estimating the royalty on sales that a third party would have to pay to obtain the right to use a name.²²

Changing accounting standards have resulted in acquired brands appearing on the balance sheet in more countries around the world. In corporate transactions, intangibles can form a significant part of a due diligence exercise. Brand asset value may also be tracked over time, and shareholders are requesting information about the strategy underpinning brands and expected future cash flows.

In our view, brand and reputation are much like any corporate asset, and should be managed as such. Building and maintaining one's brand is increasingly more expensive. Marketing is a significant investment for most Retail and Consumer companies. PwC research indicates that most consumer goods companies will spend between 10% and 20% of sales on advertising, promotion, and marketing initiatives. Reputation, like a brand, has value – and like a brand, the effort and cost necessary to maintain a successful reputation is going up.

Because it is difficult to value a company's reputation when all is going well, some studies value reputation by assessing the costs associated with a reputation crisis.²³ One author, for example, estimates that a large automotive manufacturer lost \$5 billion in reputation value resulting from the recall of the tires on one of its key models.²⁴ Companies facing reputation crises generally

lose market value. To some extent, the loss constitutes the stock market's best guess about the damage done to the company's future profitability – which is closely linked to its credibility and reputation.

The insurance industry has been studying reputation value as part of its efforts to develop an insurance product to cover financial losses resulting from events adversely affecting reputation.²⁵ A number of large companies have expressed interest in protecting against loss of shareholder value resulting from damaged reputation.²⁶ Proponents of reputation risk insurance contend that brand-value best represents the financial value of corporate reputation, at least for purposes of insurability. According to one expert, brand value represents approximately 5-7% of a company's market capitalization.²⁷ At Retail and Consumer companies, the percentage would likely be higher given the magnitude of the significance and heavy reliance upon brand value.

Reputation, even if its financial worth is sometimes difficult to precisely quantify, constitutes a significant asset. And, a loss of reputation equity often leads to a material financial loss.



²²Fombrun at 90

²³Larkin at 6

²⁴Id.

²⁵R. Harris, Picking Up The Pieces, CFO Magazine (August 2004)

²⁶Id.

²⁷Id.

The single most important step

“Reputation, reputation, reputation! Oh, I have lost my reputation!
I have lost the immortal part of myself, and what remains is bestial.”
W. Shakespeare, *Othello*. Act II. Scene 3.

The single most important action item to reduce reputation risk is to inventory and prioritize the universe of events, which, if they should occur, would negatively impact corporate reputation. These can be developed in a matrix format (see Step 2 of PwC’s Five-Step Reputation Risk Management Plan). Developing a “reputation risk events inventory” and mapping the issues into a “risk issues matrix” is a formidable challenge, as the universe varies by company, brand, and market. Moreover, companies must look across the entire organization, as even the least significant business unit can give rise to enormous risks to reputation. A surface level assessment is not enough, as true “root causes” are often hidden deeper within. The following section entitled “*Applying COSO-ERM to Reputation Risks*” shows how reputation risk events can be categorized based on four broad company objectives, and the section entitled “*Key Retail and Consumer Reputation Risks*” provides examples of specific areas where risks to brand and reputation are likely to occur for Retail and Consumer companies, categorized by these four company objectives.

Once the reputation risk events inventory is developed and potential root causes are identified, the other elements of the reputation management plan can be developed and implemented, as further outlined in PwC’s Five-Step Reputation Risk Management Plan. Retail and Consumer companies that have been through the Sarbanes §404 compliance process may have an advantage, as some of the processes already in place for §404 compliance may be leverageable in addressing reputation risk. Companies, however, must be committed to investing the necessary time and resources to develop a risk tolerance strategy, design reputation controls, and conduct simulations. In addition, companies should be cautioned in understanding that although there may be some overlap in controls developed for the Sarbanes §404 compliance exercise, many of the controls that



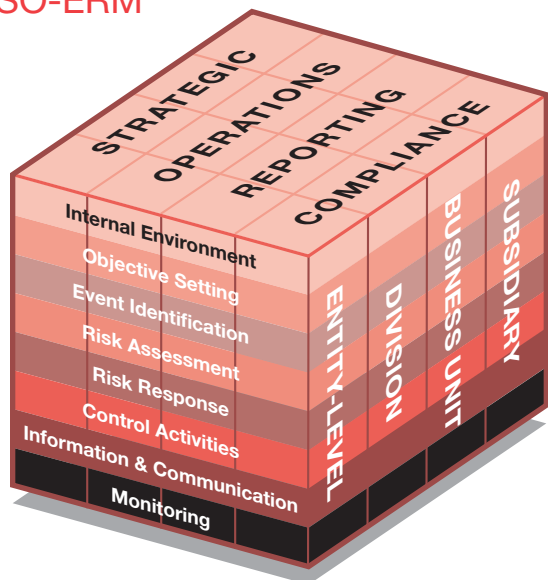
are key to reputation risk may lie outside the financial reporting focus of Sarbanes.

Applying COSO-ERM to reputation risks

Publicly traded Retail and Consumer companies likely will have just completed or are in the process of completing their documentation and assertions of the effectiveness of internal control over financial reporting. Most companies use the *Committee of Sponsoring Organizations (COSO) Internal Control – Integrated Framework (COSO-Internal Control)* as the basis for making this assertion.

In September 2004, COSO issued its *Enterprise Risk Management – Integrated Framework (COSO-ERM)*, which expands upon the COSO-Internal Controls model and serves as an excellent foundation for building a practical reputation risk management framework.

COSO-ERM



Objectives

Similar to the COSO-Internal Controls model, the top side of the COSO-ERM cube represents the company's objectives, which are described in four broad categories:

1. Strategic – relating to the corporate mission and high-level goals
2. Operations – relating to use of corporate assets and resources
3. Reporting – relating to the reliability of corporate reporting
4. Compliance – relating to compliance with laws²⁸

Risk events affecting any of these four categories often implicate a company's reputation equity. For instance, risks to reputation arising from the restatement of financial statements, especially in the context of Sarbanes, negatively affect reporting and compliance objectives. Similarly, risk events arising from child labor or wretched working conditions at a third-party manufacturer adversely affect operations and compliance objectives. In addition, partnering relationships (such as outsourcing production to third world countries, or contracting with companies that employ illegal immigrants as part of a low-cost strategy) can be at odds with the company's public mission and violate strategic objectives. The later section entitled "Key Retail and Consumer Reputation Risks" provides additional examples of reputational issues and events that can occur in each of the COSO-ERM categories.

Deeper than corporate

The right side of the cube depicts the company's organizational structure. COSO-ERM distinguishes risks at the Entity-Level, and within Division, Business Unit, and Subsidiary levels.

Effective reputation risk management programs drill deep below the corporate level and sometimes even deeper than that required under Sarbanes. That is because even the least financially significant business unit could pose a huge reputation risk. Retail and Consumer companies simply cannot afford to overlook business units simply because they are immaterial to the financial statements or because they engage in a non-core business activity. Prioritizing a company's focus will require expertise and judgment.

Components of risk management

The front side of the COSO-ERM cube depicts the eight components of Enterprise Risk Management.

1. *Internal Environment* – relating to corporate culture and mission
2. *Objective Setting* – aligning objectives, mission, and risk appetite
3. *Event Identification* – anticipating potential events that, if they occur, would impact the organization's ability to realize objectives
4. *Risk Assessment* – evaluating the likelihood and significance of potential events within a company's core activities (product development, health & safety, environmental, and employment policies)
5. *Risk Response* – responding by avoiding, accepting, reducing, and sharing risks
6. *Control Activities* – implementing responses through policies and procedures
7. *Information & Communication* – capturing and sharing relevant information across the organization
8. *Monitoring* – scrutinizing risk management through a combination of ongoing management activities and after-the-fact separate evaluations

Each of these risk management components is relevant to the concept of managing risks to reputation, as further demonstrated in PwC's Five-Step Reputation Risk Management Plan.

²⁸ COSO-ERM at 21. COSO-ERM lists four objectives whereas COSO-Internal Controls lists three. COSO-ERM adds the "Strategic" objective, which was not included in the COSO-Internal Controls model. Effective reputation risk management requires consideration of reputation risk in developing strategic objectives. Reputation risk, for example, is an important, but often absent, consideration for Retail and Consumer companies in determining whether a company should make an acquisition or enter into a joint venture. Another difference is that COSO-ERM refers to "Reporting," whereas COSO-Internal Controls uses the phrase "Financial Reporting." COSO-ERM thus expands "Reporting" to include all internal or external reports of the entity, and not just published financial statements. Every corporate communication potentially impacts reputation, whether it is an advertising claim to the general public or an internal employee memo.

Leveraging Sarbanes-Oxley antifraud program efforts

“If you can’t get rid of the skeleton in your closet, you’d best teach it to dance.”

George Bernard Shaw

Companies subject to Sarbanes must implement “antifraud programs and controls”.²⁹ Retail and Consumer companies can address reputation risk by leveraging work conducted to meet this Sarbanes requirement. PwC’s whitepaper, *Antifraud Programs and Controls in the Retail and Consumer Sector*, identifies the key elements of an antifraud program, including common fraud risks, and provides an action plan for implementing an effective antifraud program based on the core principles shared by new laws, regulations, and standards. Copies of that whitepaper can be obtained from PwC’s Retail and Consumer industry Web site at www.pwc.com/retail.

For most Retail and Consumer companies, leveraging off of the Sarbanes’ antifraud program requirements will mean expanding management’s fraud risk assessment to include reputation risks.³⁰ Comprehensive scheme- and scenario-based fraud risk assessments are critical to antifraud programs and controls. To be effective, a company must identify its potential fraud risks, assess the likelihood and significance of fraud, link preventive and detective control activities to identified fraud risks, and monitor residual fraud risks to avert smaller frauds from emerging into corporate scandals.

Retail and Consumer companies can apply their fraud risk assessments more broadly to identify “what could go wrong” and, thus, damage reputation, and in linking risks to control activities and monitoring residual risk.



²⁹ See J. Frank and N. Newman-Limata, A New Audience for COSO-SEC & PCAOB Requirements for Anti-Fraud Programs & Controls, BNA Prevention of Corporate Liability (April 2004)

³⁰ See PwC, Emerging Role of Internal Audit in Mitigating Fraud and Reputation Risk (May 2004), available from PwC’s internal audit practice website at www.pwc.com/extweb/pwcpublishings.nsf/docid/290B54AA6A3BA9F485256E6A0068B5E6

Key retail and consumer sector reputation risks

“Glass, china, and reputation are easily cracked, and never mend well.”

Benjamin Franklin

Some reputation risks encompass every industry. Fraudulent financial statements are always damaging, no matter whether the entity is a retail, banking, or manufacturing concern. Because Retail and Consumer companies ultimately sell products to an end consumer, they must be careful to ensure the utmost integrity of their “brand.” Few customers are willing to place trust, once again, in a company that sells a product that fails to meet the standards demanded by today’s discerning consumer.

The larger Retail and Consumer companies may have a comprehensive portfolio of brands and associated products and may sell them in dozens of diverse markets. The sheer size and complexity of these organizations

makes the task of eliminating risks to the reputation of any one product or even to the corporate parent extremely difficult. However, eliminating brand reputation risks is a critical management responsibility in Retail and Consumer companies, even more so than in certain other segments because of their direct involvement with the end-user or consumer.

In addition to the financial reporting-related areas required to be tested under Sarbanes, Retail and Consumer companies will need to assess reputation risk in other areas where risk to brand and reputation could occur, including but not limited to:

- Manufacturing standards
- Product sourcing
- Product labeling
- Workplace conditions
- Co-manufacturing alliances
- Product safety and effectiveness
- Regulatory compliance
- Advertising and promotional governance
- Customer purchase and privacy data
- Sales policies and tactics
- Product distribution

These additional assessment areas fall into well defined risk categories corresponding with the four COSO-ERM objective categories: *Strategic*, *Reporting*, *Operations*, and *Compliance*. Reputation issues and events may potentially occur in any one of these categories, as highlighted in the following examples.





Strategic

- Acquiring a company that engages in illegal or immoral business practices
- Entering high risk geographic markets or industry segments

Reporting

- Incomplete or inaccurate product labeling
- Inaccurate or untruthful advertising claims
- Misrepresentation of market research results
- Channel stuffing to meet quarterly or annual sales goals
- Inappropriate reporting of vendor allowance arrangements
- Financial statement inaccuracies and/or restatements
- Reported material weaknesses

Operations

- Lack of integrity in product manufacturing
- Unethical hard-sell or dishonest sales tactics
- Sale of an unsafe product with risk of injury
- Sales promotion deception
- Lack of commitment to fair trading practices

- Use of child labor in manufacturing, particularly in third world countries
- Poor or unsafe working conditions
- Environmental abuse in manufacturing
- Non-sustainable development practices
- Unhealthy products
- Product tampering
- Quality issues with supplier purchases
- Outsourcing to unethical manufacturers

Compliance

- Use of bribes or questionable payments to secure illegal sales
- Channel stuffing to meet quarterly or annual sales goals
- Product component substitution
- Failure to adhere to customer privacy/opt-out guidelines
- Unauthorized sale of customer purchase data to third parties
- Inappropriate governance over executive pay packages
- Late SEC filings
- Sarbanes non-compliance

PwC's five-step reputation management plan

“A single lie destroys a whole reputation of integrity.”

Baltasar Gracian

PwC has developed a Five-Step Reputation Risk Management Plan for Retail and Consumer companies that builds upon the COSO-ERM model and our approach to Sarbanes Antifraud Programs and Controls. *Step One* establishes a team and baseline, including assembling a senior-level, multidisciplinary team, identifying stakeholders, and criteria, and suggests a present state analysis to identify and cure gaps. *Steps Two* through *Four* apply concepts and principles from COSO-ERM and Sarbanes Antifraud Programs and Controls to identify potential events, assess likelihood and significance, develop and evaluate reputation controls, and monitor residual risks. Finally, *Step Five* recommends that Retail and Consumer companies simulate occurrence of reputation damaging calamities, just as pilots simulate the unexpected, to ensure that the company's incident response and remediation plan is ready to prevent insignificant events from becoming catastrophic.

Step One: Establish a baseline

Assign responsibility to individual business unit leaders

Managing reputation risk demands active and visible backing from senior management. Senior management, in turn, must persuade business unit and function leaders to take ownership of managing reputation risk.

Managing reputation risk cannot be left solely to risk management, internal audit, brand management, or other corporate shared-services centers. Business unit and function leaders must take an active role in the process. Not only does this approach reinforce responsibility, but individual business unit and function leaders are well



situated to assess reputation risks and root causes, as they have a deep understanding of their business areas. One Fortune 50 company formally reinforces ownership and accountability by requiring individual business unit and function leaders to make formal presentations to senior management and/or the audit committee.

Delegating assessment to the business units, however, requires coordination, takes time away from other duties, and can be expensive, depending upon the required level of coaching and consultation. PwC recommends a hybrid approach that delegates assessment to individual business unit and function leaders, supported by a senior reputation management leader and a multidisciplinary team. The team might be comprised of outside consultants and senior management representatives from various areas such as corporate strategy, operations, compliance, procurement, manufacturing, distribution, sales and marketing, and internal audit.

Identify stakeholders and criteria

It is not sufficient to aspire to have a “good” reputation. Retail and Consumer companies must determine how to maintain a strong reputation with each of the various stakeholder groups at the same time. Creating that balance can be difficult, but is essential to effective reputation management.³¹ In creating this balance, Retail and Consumer companies must frequently evaluate various stakeholder groups (customers, employees, suppliers, investors, and society), prioritizing them by their relative importance. In addition, they must evaluate elements that give rise to the desired reputation in relation to stakeholder concerns. Assume, for example, that the company seeks a reputation of being “generous” to its employees, or a reputation of being “fair, but tough” with its suppliers. The reputation management team needs to identify factual elements that would give rise to such a reputation.

The Appendix provides a starting point for identifying and prioritizing stakeholders, their criteria, and mapping their key concerns. Drawn upon various studies and surveys regarding reputation, the Appendix consolidates reputation criteria by stakeholder group. These attributes are a mixture of those considered as driving corporate reputation in determining a company’s Reputation Quotient, and its position in the Delahaye Index and the annual listing of Fortune’s Most Admired U.S. Companies.

Perform a reality check

The baseline should include a present state analysis to understand the company’s reputation equity position among its various stakeholders. Some Retail and Consumer companies misconstrue how their customers, employees, investors, and other stakeholders truly view the company’s reputation. The key to success in conducting a present state analysis is in making an honest assessment, measuring the company’s strengths and weaknesses, and comparing them against the company’s key competitors.³² Surveys or interviews can quickly provide a snapshot of the company’s reputation equity with key stakeholders – and can be conducted by an internal group, such as a market research department, the company’s advertising agency, or other independent third party.

Step Two: Predict the unpredictable

Identifying potential events that give rise to reputation risk is the single most important element of a reputation risk management program; events can range from the obvious (product failure) to the obscure (unanticipated action taken by a special interest group).³³ Investing time and resources into event identification will uncover previously unidentified risks and enable Retail and Consumer companies to prevent, detect, and mitigate potentially reputation-damaging scenarios. Although there is no ‘one way’ to conduct this assessment, PwC suggests the approach described herein, noting that the process must be customized for individual companies, their business units, and functional areas.

PwC has helped a number of companies manage a similar challenge in addressing Sarbanes’ requirements for antifraud programs and controls. Anticipating fraud risk is the cornerstone of an effective antifraud program, while anticipating reputation risks is key to implementing and sustaining an effective reputation risk program. The critical information lies internally within the company; yet, few companies have the requisite knowledge and experience to unlock this information.

Create a framework for organizing risks

PwC suggests grouping potential risk events affecting reputation into categories and aggregating them horizontally across an entity and vertically within operating units consistent with the COSO-ERM model (*Strategic, Operations, Reporting, and Compliance*).³⁴ However, there is no right or wrong way of categorizing events. Table 3 provides an illustration, using several reputation risk events previously identified as common to Retail and Consumer companies.

Table 3: Sample reputation risk event categories

Strategic	Operations
<ul style="list-style-type: none">• Mergers and acquisitions• Entering high risk markets	<ul style="list-style-type: none">• Manufacturing standards• Dishonest sales tactics
Compliance	Reporting
<ul style="list-style-type: none">• Bribery• Product component substitution	<ul style="list-style-type: none">• False advertising claims• Financial statement misstatements

³¹ Alsop at 37

³² Alsop at 25

³³ COSO-ERM at 41

³⁴ COSO-ERM at 45

Populate framework with a reputation risk events inventory

Developing a Reputation Risk Events Inventory is a pessimist's utopia, as the team seeks to envision any and all incidents that might negatively impact the company's reputation. PwC recommends that this process be done without regard to existing controls or probability of occurrence. Sample techniques include:

- Industry research
- Existing event inventories
- Brainstorming techniques
- Web-based and other surveys
- Process flow analysis
- Field interviews and focus groups

Companies should resist the temptation to disregard field interviews and focus groups, as mid- and lower-level employees understand the inner workings of the company and are an invaluable source for unlocking risks hidden or unnoticed by senior management.

Step Three: Measure likelihood and significance

Next, the team should assess (1) the likelihood that the event will occur, and (2) the event's potential significance and impact on reputation equity, should it occur.

Predict likelihood

Retail and Consumer companies that have undergone either a Sarbanes review or enterprise-wide risk assessment will be familiar with assessing likelihood of occurrence. For the purposes of this evaluation, likelihood should be considered without regard to controls.

To leverage the Sarbanes exercise, PwC recommends that the team consider using the same likelihood scales used in the Sarbanes §404 compliance process for assessing financial statement risks:³⁵

- Remote (likelihood of event occurring is slight)
- More than remote (likelihood of event occurring is reasonably possible, but less than likely)
- Probable (event is likely to occur)

Predicting the likelihood of reputation risk events is difficult — and risky to the team that will likely be blamed

if a risk categorized as “remote” actually occurs. The team must dig into the factors and circumstances that would give rise to the reputation impacting event. Does, for example, the potential event involve intentional conduct? If so, the team should determine what incentives or pressures exist that would motivate the intentional conduct. If a likely motive is identified, the probability that an event will occur will generally be higher. Another question to consider: Is the potential event internally or externally driven? Because companies have less control over outside forces, external events are often weighed as having a greater likelihood of occurrence than events that companies can control.

PwC cautions companies against ignoring events whose likelihood of occurrence is deemed to be remote. Common sense dictates that Retail and Consumer companies must address certain key reputation risks, such as product safety, even if there is only a slight chance of an occurrence.

Gauge potential significance and impact

Retail and Consumer companies can also leverage their Sarbanes experience in gauging the significance and impact of risk, by categorizing them in a manner similar to that used in the Sarbanes §404 compliance process:

- Inconsequential
- More than inconsequential
- Material

Sarbanes uses the terms for measuring the significance of a misstatement to users of the financial statements.³⁶ For the purposes of reputation risk management, the team should consider the importance of the potential event to the particular stakeholder and reputation criteria. For instance, an event might be vital to a customer, but quite unimportant to a supplier.

Preventability is an important factor in determining significance and impact. If the event is perceived to be preventable (i.e., within the control of the company), the potential harm to the company's reputation is much greater.

If an event is determined to be preventable, consider whether the stakeholder(s) will perceive the event as a systemic flaw or as an isolated occurrence. All other things being equal, the impact from an event as a result of a systemic flaw will be much harsher.

³⁵ Public Company Accounting Oversight Board, Auditing Standard 2.9 (quoting Financial Accounting Standards Board Statement No. 5, *Accounting for Contingencies*); see PricewaterhouseCoopers, *Antifraud Programs and Controls in the Retail & Consumer Sector* (2004) and PricewaterhouseCoopers, *Emerging Role of Internal Audit in Mitigating Fraud and Reputation Risk* (2004).

³⁶ AS2.23

The organization's response will also be critical. A perceived ineffective response will aggravate the harm to reputation. An effective response, conversely, may not only preserve the company's reputation, but might also enhance it, as demonstrated by a well-publicized product tampering incident several years ago affecting a large well-respected OTC drug manufacturer.

Attempting to measure the significance and impact of an event that has not yet occurred can be difficult. Importance varies by stakeholder and is highly fact specific. Retail and Consumer companies should not be too hasty to dismiss a potential event as being inconsequential to reputation.

Step Four: Develop a risk tolerance strategy and mitigating controls

Avoid, accept, share, or reduce

The next step is to develop a risk response to events, which, if they occurred, would have a more than inconsequential impact on reputation. COSO-ERM presents four general responses:

- Avoidance
- Acceptance
- Sharing
- Reduction

Avoidance

Avoidance very simply means not engaging in the activity that could give rise to reputation risk. Of course, many Retail and Consumer company reputation risks simply cannot be avoided, as they are typically inherent to the business.

Certain risks, however, can be avoided. For example, Retail and Consumer companies should consider reputation risk before entering a merger, acquisition, strategic alliance, or other large transaction. Reputation disaster may be easily avoided by inquiring into the integrity of the management team and operations of the counterparty.

Acceptance

Under an acceptance strategy, the company assumes the risk. This strategy, for Retail and Consumer companies, can be quite dangerous, given the importance of reputation. Yet, Retail and Consumer companies – albeit unwittingly – routinely accept significant reputation risks. For example, many engage in manufacturing or sell products in countries where association with undesirable suppliers or resellers is highly likely, if not, unavoidable.

As a practical matter, Retail and Consumer companies must assume certain reputation risks as a business reality, particularly when there is no feasible alternative. Effective reputation management requires that companies accept such risks knowingly, however, and with a plan in mind.

Sharing

A sharing strategy applies to risks that can be split and shared among two or more parties. Insurance arrangements between insurer and insured typify risk sharing. Reputation risk is not a good candidate for sharing because unquantifiable risks are difficult to split and apportion.

Attempting this strategy can be quite dangerous for Retail and Consumer companies. Consider, for example, outsourcing arrangements in emerging markets. Retail and Consumer companies might believe that reputation risks associated with poor labor conditions can be shared or even avoided by engaging third party manufacturers – however, experience teaches that this is not so. Marketplace examples of working conditions in the apparel industry illustrate the devastating impact to a company's reputation that can arise from deferring responsibility to a third-party manufacturer.

Reduction

Retail and Consumer companies, in most instances, will respond through a reduction strategy; that is, mitigation of identified risks through preventive and detective control activities. An example might be to anticipate a potential reaction from an activist group and alter product development and marketing plans accordingly.

Implement preventive, detective, and responsive controls

All four risk responses require the presence of effective operating controls – even an avoidance strategy requires that effective controls be in place to ensure the company does not engage in activities to be avoided. If controls currently exist, the first step is to identify and link those existing control activities to identified reputation risks. If none exist, the company must then determine what controls need to be developed.

Link existing control activities

Retail and Consumer companies subject to Sarbanes, particularly those that have implemented effective antifraud programs, are well-positioned to leverage their previous work. There is a natural overlap between reputation risk and fraud risk. Companies with effective antifraud programs will have already linked control activities to identified fraud risks. Some of these may also map to a reputation risk. Do not expect complete coverage, however, as internal controls covered by Sarbanes §404 focus exclusively on financial reporting risk. The team therefore will need to consider operational, compliance, and strategic control activities, as well as other reporting controls in linking existing control activities.



Develop preventive, detective, and responsive control activities

Internal controls, such as those over financial reporting, generally include preventive and detective controls. Reputation risk management requires a third category, which we refer to as a “responsive” control; that is, a ready response plan to mitigate damage when a reputation event occurs.

Developing reputation controls should not be a ‘starting from scratch’ effort for most Retail and Consumer companies that either have historical processes in place for developing and implementing controls, or have formalized processes as part of the Sarbanes §404 exercise. However, because of the nature of reputation risks, many reputation controls will have a different look and feel from traditional financial reporting and operating controls. As a result, companies will likely need input and participation from subject matter experts either from within the company (i.e., marketing, public relations, etc.) or from outside sources.

Step Five: Evaluate controls and simulate reputation events

A robust evaluation of control activities, such as is required by Sarbanes §404, includes two components: design effectiveness and operating effectiveness. Design effectiveness evaluates whether, if the control operates as designed, the control objective will be met, including whether all the controls necessary to meet the control objective are present.³⁷ Operating effectiveness evaluates whether a properly designed control is operating as designed and whether the persons performing the control possess the necessary authority and qualifications to perform the control effectively.³⁸

Once again, Retail and Consumer companies subject to Sarbanes §404 compliance should be able to leverage prior work, as operating effectiveness of certain reputation risk controls will likely have already been tested. Even in these circumstances, however, companies will need to re-evaluate design effectiveness. Controls that are properly designed to meet one control objective might not be properly designed to meet another. Companies will also need to evaluate, test, and validate operating effectiveness of controls that were not tested under Sarbanes, as well as new controls developed as a result of the reputation risk assessment.

It is vital that the Board of Directors be informed of any critical issue as soon as it arises. Thereafter, directors should play a key role in advising management and even approving key actions and messages. Forward-thinking boards will want to discuss with management any plans to address crises before they develop.

Finally, Retail and Consumer companies should plan to simulate reputation events to ensure readiness if an actual event were to occur. Many companies, by way of comparison, now practice physical evacuation and other security procedures. Companies that practice frequent crisis simulation drills are known to be more effective in dealing with negative situations when they occur. PwC recommends simulation of dire reputation impacting events – whether they are allegations of tainted product, announcement of a government investigation, or an incident at a store location. If a negative event or disaster occurs, it is important that investor relations, employee communications, and public relations departments are galvanized to operate under the same game plan, and that there is consistency in internal and external messages.³⁹

³⁷ AS2.8

³⁸ AS2.8

³⁹ Alsop at 4

Closing Thoughts

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Amid the fast moving, consumer-demanding, and complex Retail and Consumer business environment, it is important for companies to understand potential risks to their reputation and brands and to be proactive in initiating and formalizing a plan to manage and reduce risks. All too often, Retail and Consumer companies become aware of damaging reputation issues only when it's too late – when a scandal looms or a crisis has already hit. Although it is virtually impossible to imagine every potential event affecting reputation, having an overall plan for anticipating, identifying, mitigating, and reacting to an event crisis can effectively help corporations protect their reputations and sustain long-term viability.

The consequence of simply reacting to an event crisis, as opposed to being prepared with a well-developed mitigation and response plan can be extremely costly to Retail and Consumer companies. With greater dependency upon consumers than some other industries and with consumers demanding that companies take responsibility for actions detrimental to their – and others' – interests, the impact of a damaging event can be devastating to a Retail and Consumer company's value. A consumer can "walk" too easily, especially with loyalty on the wane, and purchase products from competitors with untarnished reputations and greater attention to brand accountability and sustainability.

A strong reputation has a financial, as well as an operational value. Management has a duty, therefore, from a corporate governance perspective, to ensure that a company's reputation is protected with respect to all key stakeholder groups. In addressing reputation risk, companies can leverage their attention to antifraud programs and controls as mandated by Sarbanes, as well as the risk management concepts outlined in the new COSO-ERM model.

Reputation risk is inherent and should be a key concern of companies in the Retail and Consumer industry. With an emphasis on readiness, Retail and Consumer companies can mitigate and minimize potential damage from adverse events and protect the value of their greatest asset...their brand reputation.

Appendix

Reputation risk criteria and stakeholders

The following chart lists the attributes of corporate reputation vertically and the stakeholders horizontally. These attributes are a mixture of those considered as driving corporate reputation in determining a company's Reputation Quotient, its position in the Delahaye Index, and the annual listing of Fortune's Most Admired U.S. Companies. The Delahaye Index also considers stakeholder relations as one of its five key drivers of corporate reputation. This chart summarizes how many attributes may impact stakeholder relations.

When an attribute is positive to a stakeholder, the result is an opportunity for the company, in varying degrees – and companies become successful by capitalizing on such opportunities. When an attribute is negative, however, there is a risk to the company. These risks and how they may impact a company's reputation are challenging to manage. The impact of a negative attribute on a

company's reputation may depend on when the risk arises and whether it is surrounded by other positive or negative attributes. A company that is capable of preventing negative attributes and/or managing the perception by stakeholders of those negative attributes will be more successful in maintaining or enhancing its reputation. Successfully managing reputation risk is, and will continue to be, an important characteristic of leading companies.

The chart summarizes the impact on a stakeholder of an attribute being negative as follows:

H	High risk
S	Some risk
O	No risk
+	Positive (i.e., an opportunity)

Stakeholders and Attributes Ranked by Importance

Stakeholders' Attributes	Consumers/ Customers	Suppliers/ Partners	Employees	Shareholders/ Investors	Securities Analysts	Community/ Society	Government/ Regulators	Competitors
Emotional Appeal								
- Good feeling about the company	H	H	H	H	H	H	S	+
- Admire and respect the company	S	S	H	H	S	H	S	+
- Trust the company	H	H	H	H	H	H	H	+
Products and Services								
- Stands behind products/ services	H	S	H	S	S	H	H	+
- Offers high quality products/services	H	S	H	H	S	H	S	+
- Develops innovative products/services (first to market, new features, design)	H	S	S	H	H	O	O	+
- Offers products/services that are good value (properly priced)	H	S	S	S	S	S	O	+
- Products are better than competitors' (best in class, top rated)	H	S	S	H	H	S	O	+
- Strong branding and communications	S	S	S	S	H	S	O	+
- Standard setter	S	S	S	S	H	O	O	+
- High market share	S	S	S	H	H	O	O	+

	Consumers/ Customers	Suppliers/ Partners	Employees	Shareholders/ Investors	Securities Analysts	Community/ Society	Government/ Regulators	Competitors
Stakeholders' Attributes								
Vision and Leadership								
- Has excellent leadership (CEO strength, overall management)	S	H	H	H	H	S	S	+
- Has a clear vision for the future	S	H	H	H	H	S	S	+
- Recognizes/ takes advantage of market opportunities	S	H	S	H	H	S	S	+
- Thought leader (agenda-setter)	O	H	S	H	H	H	S	+
Workplace environment								
- Is well managed	S	H	H	H	H	S	H	+
- Looks like a good company to work for (employer of choice, best place to work)	S	H	H	S	H	H	S	+
- Looks like it has good employees	S	H	H	H	H	H	S	+
- Fosters entrepreneurship (innovative organization, management and employees)	S	H	H	H	H	S	S	+
- Strong corporate culture	S	H	H	H	H	S	O	+
- Reasonable treatment of employees (pay, healthcare, job security, relationships with unions, and avoidance of layoffs)	S/H	H	H	S	S	H	H	+
Financial performance								
- Record of profitability (current and projected)	O	S	S/H	H	H	O	S	+
- Looks like a low risk investment (consider company's financial history, including past performance, stock price, bankruptcies, recapitalizations)	O	H	S/H	H	H	O	S	+
- Strong prospects for future growth (current and projected revenue growth)	O	H	S/H	H	H	O	S	+
- Tends to outperform its competitors	O	S	S/H	H	H	O	S	+
- Capital structure (IPO, debt rating)	O	S	S/H	H	H	O	S	+
- Cost control (current and projected)	O	O	S/H	H	H	O	S	+
- Stock performance (current and projected)	O	O	S/H	H	H	O	S	+
Social responsibility								
- Supports good causes	H	S	H	H	S/H	H	S	+
- Environmentally responsible	H	S	H	H	S/H	H	S/H	+
- Treats people well	H	S	H	H	S/H	H	S	+
- Clearly operates within legal, regulatory, and ethical bounds	H	H	H	H	H	H	H	+
- Corporate governance (transparency, board independence, clean audit opinion)	S	H	H	H	H	H	H	+

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