Editorial

The Valuation and Reporting of Reputation Risk Management Capability

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Abstract

This paper advances some issues related to an accountor's evaluation of the worth of a corporation. By 'accountor' it is meant a body of persons who the future worth of the corporation. It is therefore argued that several more dimensions of the firm have to be audited or evaluated by accountors, not just the accuracy of the worth of the firm based on the past transactions. Such an evaluation should also include the governance quality of the management.

The paper proposes that the firm should be evaluated in terms of its' capability' to protect and enhance its reputation and hence its future earning power; and that Risk Management is a strategic accounting approach in which a firm's reputation risk is not only both managed and enhanced, but also reported and attested.

Finally, the paper suggests an approach that auditors can take to determine a firm's strategic capability of sustaining and generating value via reputation enhancement.

Keywords

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Triple Bottom Line
Corporate Governance
Strategic Audits

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Introduction

The age of the corporation (since 1850) led to the enormous emphasis on the determination of profit - hence the acceptance of arbitrary cost allocations. Now the focus has widened. Owners, investors, creditors, bankers, government now all need *leading indicators*. Accounting - especially financial accounting reporting- is still preoccupied by *lagging indicators*.

Such a preoccupation with the past is akin to *"navigating by looking at the wake created by the ship"*. This is not helpful if there are icebergs out in front.

This paper argues that the overriding reason for governance is ultimately the safeguarding of an organisation's reputation, and that this requires an integrated approach where the 'accountees' (corporations), and its investors and regulators are provided with appropriate information by the 'accountors', i.e. the accounting profession. Unfortunately, the ' accountors' have relied for the last 500 years on the financial accounting reporting model, last significantly updated only during the period of the 'industrial revolution'. The resulting information provided by this model has, inevitably, caused many a 'Titanic' in the corporate world, especially in the last two decades.

In the early 1990s, corporate bankruptcy increased to an all time high around the world (Webb, et. al 1991). During this period, media reports regarding myopic auditors were almost as numerous as those regarding deceitful directors (Kohler, 1991). What was the accounting profession's response at that time? Increased regulation, increased compliance, increased accounting standards (Tweedie, 1991). Then, 10-years later, came Enron, WorldCom, Ansett, OneTel, Parmalot. Collapses in all parts of the world. What is the accounting profession's response this time? Again, increased regulation, increased compliance, increased accounting standards, but with a twist. The financial accounting profession now claims that the panacea is "convergence" via the International Financial Reporting Standards (IFRS), i.e.

one set of international accounting standards for the world. This IFRS response has, however, been taken without any research evidence to indicate that had there been only one set of standards at the time, this would have prevented the Enron, WorldCom etc. collapses.

The financial accounting profession has pushed the IFRS bandwagon as it is in their interest do so. As a result, their compliance business has more than doubled. A new breed of auditor has evolved, the "IFRS Compliance Auditor". Having obtained acceptance of IFRS from organisations such as the World Bank, sovereign governments have been pressured to ensure that their country's accounting bodies adopt IFRS, despite the issues that brought about IFRS being totally irrelevant to many developing countries. However, non-compliance could result in World Bank and other funding being withheld, so many developing countries have no option but to accept IFRS.

The more recent collapses have been of such magnitude, however, that the financial accounting profession and its IFRS reports are no longer entrusted with the sole reporting role in the performance of an organisation and the management of its value. The legal and finance profession via legislation and stock market regulators have also become involved; in some countries with mandatory regulation such as the Sarbanes Oxley (SOX) 404 in the USA. In other countries, the regulation is still voluntary, such as the Australian Stock Exchange's 10-point Corporate Governance Guidelines. For example, SOX 404 requires CFOs and CEOs to sign-off on the accounts as well. The role of the professional risk manager has now become a key to ensuring an organisation's long-term survival.

During the prevailing years between the spectacular collapses of the early 1990s and those of the early 2000s, concerns other than good corporate governance have also arisen. Reports were demanded on the impact of the actions of corporations on the environment, and on society. "Triple bottom line" is thus the reporting extension of the concept of sustainable development, which has been defined as "development that meets the needs of the present world without compromising the ability of future generations to meet their own needs". In the modern firm, therefore, *Risk Management* is very concerned not only with ensuring good corporate governance, but also in managing all three "bottom lines", namely how an organisation's economic, environmental and social performance maintains its reputation and ultimately its value.

New Approaches to Risk Reporting

From the above discussion, it can be seen that, increasingly, the providers of "capital", (i.e. the accountees) require far more information than the financial performance of its *past activities* to ensure that the reputation and value of their investments are being properly managed - they are becoming far more preoccupied with the *future safety and performance* of their investments. Further, governments (infrastructure); employees (human assets) and environmental groups (the Earth) are also claiming to be providers of capital, thus also wanting to be regarded as 'accountees'.

In an informational-era enterprise, the distinctions between white and blue-collar workers are far less pronounced, as all workers become *knowledge workers*. The role of a risk manager, management accountant (or any other informational professional) is to manipulate the available data and provide the (often future oriented) information in terms of the new measures demanded by these knowledge workers.

Consideration should, therefore, be given to the *nature, recognition, and measurement* of information-era assets. The engine(s) that drive information-era enterprises include knowledge, innovation, communication, learning, and innovative abilities. However, such assets are still systematically excluded from our industrial-era balance sheets; thus understating the total "capital" of the enterprise. Therefore, currently "short-term monetary capital maintenance" is the focus instead of "long-term comprehensive capital maintenance". This also provides temptation to managers to reduce some of these assets for the sake of short-term earnings. For example, in earlier times, advertising was seen as an expense rather than a variable that enhances a Brand's future earnings potential (i.e. an asset). Thus there was a temptation amongst managers to increase short-term profit by *reducing* the advertising spend. Today's managers may similarly reduce the maintenance carried out on a tangible asset (e.g. aircraft), or reduce the training given to an intangible asset such as a knowledge worker (e.g. aircraft maintenance technician). If as a consequence the aircraft crashes, this could irreparably damage the reputation of the airline. In certain instances, such cost savings (e.g. on safety equipment for workers) could result in jail terms for directors.

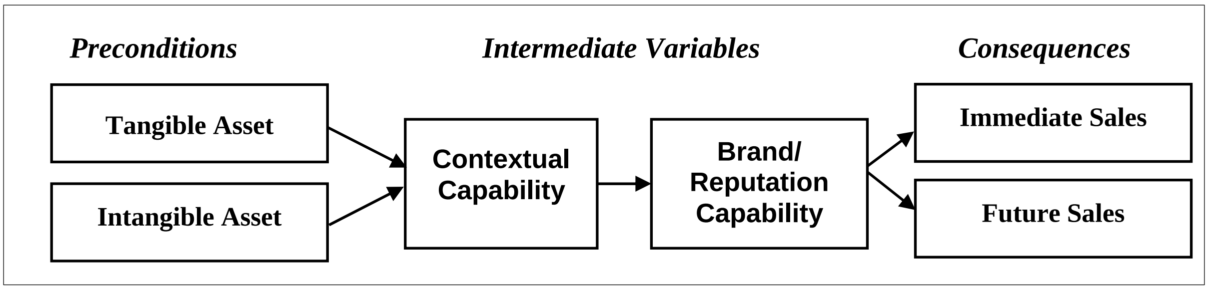
From the above discussion it is evident that the traditional financial accounting measurement model fails is in the area of valuing *intangibles*. Thus if we are to develop a new accounting model for a new age, we need new types of "measurements", for both tangible and intangible assets in order for organisations to meet the challenges present at the corporate, national and international levels, especially in the areas of decision-making, performance evaluation, risk management and organisational valuation.

It could be argued that as there are inordinate difficulties created by the accounting and auditing rules currently established to value intangible, the cure should first be to examine and tighten the *means and ways* intangibles are evaluated. For example, in merger accounting, the world is moving away from the pooling of resources accounting to purchasing after years of misrepresenting the value created in mergers.

However, it is argued in this paper that merely tightening up the *means and ways* intangibles are evaluated is unlikely to resolve the problem of reporting value, because the value of an organisation is not based on what it 'has' (be it tangible or intangible assets) but instead what one 'can do' with such assets. Therefore the solution needs to be a radical departure from the current thinking of how assets should be valued.

Figure One illustrates the issues involved. The available tangible and intangible assets are the *preconditions* required for the inducement of sales (the *consequences*). These preconditions act via an *intermediate variables* of contextual capability and brand capability (or organisational reputation) to generate both present and future sales potential. The present value of such sales potential is therefore the "value" of the contextual capability that gives rise to the brand/reputation capability. It is this brand/reputation capability which must be managed.

Figure One: Preconditions and Consequences of Capabilities



The problems associated with implementing these new measurements are immense. For example, in the marketing communications area, even if tangible assets (such as the sales force, billboards, trade promotions counters, samples, catalogues, etc) and intangible assets (brands, logos, trade marks, advertising jingles, slogans, patents and copyrights)[1] can be valued, what is especially difficult in practice is the valuation of the associated *tacit knowledge* and *judgment* required to combine these differing assets to enhance the capability (and ultimately value) of the organisation (see Ratnatunga, et al. 2004).

At this point it is important to contrast *tangible* and *intangible* assets, *contextual capability*, *brand (reputation) capability* and the resultant *capability value*. Assets are "what one has", much like a Ferrari racing car (tangible asset) or Michael Schumacher's driving skills (intangible asset). Contextual Capability is what can be achieved in a particular situation (or "what one can do") when these asset categories are combined in a contextual situation, i.e., win the World Championship. Brand/Reputation Capability is the esteem perception created in potential customers' minds about the Ferrari brand as a consequence of winning the world championship. Capability Value is the economic value of the capability (i.e. the current and future monetary value to Ferrari via sales, having a Brand Reputation of winning the formula one championship).

Any diminution of that reputation due to poor risk management techniques, ultimately results in the diminution of an organisation's value, and if this process goes unchecked, or has a significant avoidable disaster, an Enron type corporate collapse could result.

It is clear that in implementing current GAAP, financial professionals face a dilemma when it comes to valuing intangibles. This is because they want financial statements to be both *reliable* and *relevant*. Reliability is easy to achieve, but relevance is not. This is especially true when it comes to knowledge-based organisations such as Microsoft, because the intangible assets are not referenced in their statements, yet these assets are highly relevant to its stakeholders.

The Accounting Profession believes that financial statements must be 'reliable', i.e. they must be both accurate and supportable. Such reliability would suggest that if two different accountants prepared the same statements, the two answers should come close to each other, particularly if they each relied on the same hard evidence. This is why the profession has worked hard over the last 30 years to issue 'Accounting Standards' to ensure that as much subjectivity as possible is removed in their preparation. Unfortunately the result is that we have financial statements that report a company having a book value widely different to the value the market places on it.

Accounting standards achieve 'reliability' by requiring evidence of an arms-length transaction between two parties. Thus when an organisation buys an asset, such as a truck, from an external supplier, and cash changes hands, this is good evidence that the organisation now has an asset that exists (and in most cases can be physically verified, thus increasing reliability) and that a sale has been made by the supplier company, and thus a profit (or loss) can be recognised by it.

Despite the GAAP in most countries recognising that the purpose of financial statements is to also provide investors and creditors with information about future earnings prospects and cash flows (i.e. be relevant) in the case of intangible assets, because an 'arms length' transaction has not occurred (and thus their valuation fails the 'reliability' test), these are kept off the balance sheet, or the amounts paid in creating them are expensed. However, as argued before, intangible assets are equally as relevant to an understanding of the

[1] The definition of an asset used in this paper, is that of a cost incurred which has a "future economic benefit". Current financial accounting reporting standards will not recognise some of these costs as assets, such as the costs of maintaining a well-trained and motivated sales force and much of advertising costs. Many of such costs are considered has having only single period economic benefits, and thus are expensed in financial accounting reports. However, Ratnatunga et al. (2004) argue that such costs enhance the strategic capability of an organisation and thus should be considered as capability assets for future oriented decision-making.

organisation's strategic objectives. Ratnatunga, et al. (2004) proposes a valuation method to convert all such strategic expenses to assets values. The ultimate result is a Strategic Balance Sheet incorporating both tangible and intangible asset capability values.

Risk Managing the Triple –Bottom Line

TBL Reporting arose out of the sustainability agenda which was long understood as Environmental Reporting", i.e. an attempt to harmonise the traditional financial bottom line, with the environmental bottom line. However, it is turning out to be not a double bottom-line, but instead a 'triple bottom line', focusing on:

- Economic prosperity
- Environmental quality, and also
- Social justice (overlooked in the past)

To achieve the balance implicit in the 'triple bottom line' concept, we not only need: new forms of accountability, but also new forms of accounting. This does not mean that every aspect of a company's performance can - or should - be reduced to a 'common currency' of money values. However, if we are to manage a given company's performance effectively, we need to be able to measure it. TBL reporting provides a bridge between the conventional or mainstream means of demonstrating corporate success, and the more unconventional but increasingly demanding call for acceptance of a corporation's implied contract with society.

The question that must be asked, therefore, is, "What comprises an organisation's social responsibility?" Most organisations acknowledge today that they have an implied social contract, i.e. a "community licence to operate". Logic dictates that a corporation's acceptance of its part in an implied social contract then extends to an acceptance of accountability for breach of that social contract. In many organisations, this accountability rest in the hands of the Risk Manager who must ensure that this implied social contract is not breached.

Some examples of the elements of an organisation's environmental and social responsibilities are found in its record pertaining to the:

- Protection of health and safety of workers.
- Equal treatment of employees.
- Avoidance of bribery and corruption.
- Environmental protection.
- Use of child labour.
- Profit generation and payment of tax.
- Provision of secure jobs for its workforce.
- Uniformity of application of standards around the world.
- Responsiveness to public views and concerns about its performance.
- Willingness to assist with resolution of social problems.
- Support for charities and community groups.
- Support for indigenous groups.
- Product safety.

In most, if not all of the above areas, the ultimate value to an organisation in meeting its environmental and social responsibilities would be the result of contextual capability that arises when the required *preconditions* are present (see Figure One). For example, the protection of health and safety of workers requires not only a safe working environment (e.g. with such tangible assets as reliable machinery, clean buildings etc.), but also on such intangible assets as properly trained workers. Thus the costs incurred by an organisation in investing in such tangible and intangible assets, must be compared with the benefits (consequences) in terms of current and future sales that such investments will bring due to an enhanced Brand/Reputation capability.

The likelihood that a credible standard for simultaneously measuring and reporting against all three 'bottom-lines' will be available in the near term is good, given, the continued demand for "Sustainable development", the extent of public scrutiny of organisational performance reports, and the numbers and standing of corporations that have already published social and ethical reports. The more an organisation reports against the three bottom lines, the more its reputation and ultimately its value can be enhanced.

Corporate Governance and Risk Management

Corporate governance as a serious and urgent research issue has become established over the last few years especially after the public spectacle of failures of once-esteemed public firms during the first four years of the new century, as evidenced by the increasing number of codes of best practice developed by leading international bodies (refer Demirag *et al*. (2000) for a full list of publications). Attention to corporate governance is largely motivated by public interest in the economic health of corporations and society in general. However, the concept of corporate governance has got various dimensions as it potentially covers a large number of distinct economic, legal and social phenomena.

The *economic view* of corporate governance is that it has an impact on the vitality and integrity of the market system. According to Guillen (2000), corporate governance plays a key role in any economy by providing a framework for the division of labour and financial results in the firm. He reiterates the fact that a well-functioning corporate governance system can contribute to economic efficiency and perhaps even social equity whereas, on the other hand, a poorly conceived system can wreak havoc in the economy by misallocating resources or failing to check opportunistic behaviour by agents, which precipitates serious political risk for the ruling elites. Such observations have initiated discussions on corporate governance in a number of countries around the world, thus leading to the introduction of the globally recognised OECD principles of corporate governance.

At a microeconomic level, therefore, the economic view of corporate governance is that managers of the company are the custodians of the assets and their prime responsibility is to use those assets efficiently in the pursuit of the firm's objectives. That is, economists believe that creating value for the shareholders is the essence of good corporate governance. In an ideal world of corporate governance, the managers would also enjoy the freedom to manage in meeting the shareholders expectations. There has been research which suggests that investors value corporate governance in both developed and emerging economies. Thus, the certification of the veracity of the published corporate governance reports would also be given a value premium.

Despite the workings of the market mechanism and the premium investors are willing to pay for good corporate governance, recent high profile cases of governance failure (Enron and WorldCom) led to corporate misconduct whereby the public, employees and pensioners have lost billions in investment and savings at the expense of gains to insiders, much of it by fraud. These events have demonstrated that the current corporate governance mechanisms have not kept up with the free-market philosophies of the economists. Therefore, the development of robust governance tools and incentive structures in light of rapid changes in the markets and financial innovation are needed for limiting present inconsistencies and confusion assumes prime importance, despite the attractions of agents' incentive compensations.

The *legal viewpoint* of corporate governance is that it refers to the procedures and rules, explicit and implicit, that provide the incentive framework for companies to attract financial and human capital, perform efficiently and avoid corruption. These rules have evolved over time, and are *still evolving* in response to corporate failures and systemic crisis (World Bank, 1999). Those subscribing to such an approach are of the view that corporate governance is a modern expression on an issue which companies have been facing for decades i.e., that of "accountability". Corporate governance is seen as how those entrusted with day-to-day management of a company's affairs are held accountable to shareholders and other stakeholders by ensuring that the organisation has appropriate corporate structures to underpin such accountability.

The *societal (social) viewpoint* of corporate governance is that it is about communications i.e., how the company presents itself to the wider world - shareholders, potential investors, employees, regulations and other groups with a legitimate interest in its affairs. This view rests on the premise that, whilst corporate governance is principally concerned about the relationship between shareholders, management and the board in determining the direction and performance of the corporation (Monks and Minow, 2001, p.1), its scope should be even broader, encompassing other issues like the ethical standards, crisis management, reporting to stakeholders not only in strict compliance with legal issues in a country, but also in terms of social responsibility.

Despite the varied approaches of the discipline based models, the core view of corporate governance indicates that it relates to how the various constituencies that define the business enterprise serve, and are served by, the firm. Thus corporate governance is concerned with the relationship between shareholders and other stakeholders, the board of directors and management. Explicit as well as implicit relationships between the corporation and its employees, customers, creditors, suppliers, and host communities (and the dynamics of the relationships among these constituencies) thus fall within the boundary of an embracing definition of corporate governance.

Some principles of corporate governance are of universal value, most importantly, transparency and disclosure principles. Thus corporate governance is about balancing two objectives. One is to promote business enterprise by enhancing the capability of its reputation to generate current and future business (economic), and at the same time assuring accountability of business to shareholders (legal) and to society (social).

The ultimate value to an organisation in meeting its corporate governance responsibilities, be they legal, economic or social, would be the result of contextual capability that arises when the required *preconditions* are present (see Figure One).

For example, in ensuring that the Directors comply with their Fiduciary Duties requires not only a reliable executive information system (with such tangible assets as up to date computers and dedicated software), but also intangible assets such as properly qualified, knowledgeable and independent directors. Thus the costs incurred by an organisation in investing in such tangible and intangible assets, must be compared with the benefits (consequences) in terms of current and future sales that such investments will bring due to an enhanced Brand/Reputation capability.

Strategic Risk Management and Audit Certification

Subramaniam and Ratnatunga (2003) state that to ensure adequate risk management, strategic information reports should be developed to link long-term or strategic goals of an organisation with performance evaluation outcomes, and therefore that appropriate strategic audit techniques would also be required.

A *Strategic Audit* is far different from the common perception of financial audits. It is a continuous evaluation of all the strategic functions of any success-seeking firm. Due to such a wide scope, strategic audit issues are pertinent to management accountants, business analysts, audit directors, senior managers and executive-level management, as well as those aspiring to become someone who oversees audit, security, compliance and control functions.

For example, the scope of the audit will certainly be different if *Strategic Balance Sheets* are adopted by companies, as the more traditional audit will need to be expanded to cover future oriented strategic audit based certifications, such as giving an opinion on the valuation approaches used to value intangible and tangible asset combinations that enhance an organisation's strategic capabilities.

Some examples of the wide-scope of strategic audits are given below.

Stakeholder Audit
Marketing Audit:
Productivity Audit:
Logistics Audit:
Service Management Audit
Customer Satisfaction Audit
Cost of Quality Audit:
Environmental Audit:
Leadership Audit:
Culture Audit
Corporate Identity Audit:
Corporate Longevity Audit:
Corporate Flexibility Audit:
Information Security Audit:
Strategic Alliance Audit:
Technology Audit:

Due to such a wide scope, strategic audit issues are pertinent to management accountants, business analysts, audit directors, senior managers and executive-level management, as well as those aspiring to become someone who oversees audit, security, compliance and control functions. Similarly, Strategic Audits could not only dwell on highly technical matters, but also provide management and other stakeholders a perspective on information systems and technology issues at the strategic level. This will in turn promote good corporate governance by enabling managers to make well-informed planning and resource decisions that will ultimately enhance the value of the organisation.

It is realised however, that valuing the future worth of an organisation based on its capabilities is a different problem from that of what historically has been the job of the auditor narrowly defined to establish the accuracy of records of the current worth. As is well known in finance literature, attempt to gauge the future worth is also beset with its own problems. Importantly, in a world mandated legally to establish such a future worth, charlatans would certainly come forward to establish the future value the firm, and sign off their names willingly for a large compensation. Therefore, it is imperative that the proper professional training and safeguards are established which would also include future valuation standards and significant penalties for those deviating from these standards.

Summary

This paper argues that the overriding reason for governance is ultimately the safeguarding of an organisation’s reputation, and that this requires an integrated approach where the ‘accountees’ (corporations), and its investors and regulators are provided with appropriate information by the ‘accountors’, i.e. the accounting profession. It also argues that although the current professional accounting standards result in financial statements that are not adequate for the proper governance, an integrated approach can be taken where reputation risk can not only be managed and valued; it can also be incorporated in these financial statements.

In terms of financial reporting, there should be no controversy from the ‘accountors’ that financial statement should provide its readers (the ‘accountees’) with all material information that is both relevant and reliable. The relevance of intangibles has not usually been questioned, but the reliability of valuations, especially with relation to the valuation of its capabilities, has often been questioned.

We have argued that for proper risk management, an organisation should measure the capability of its reputation to generate value beyond its financial performance, and help managers integrate processes and resources into the organisation's overall success—an essential step toward competing in a knowledge-based environment. Just as traditional accounting tools helped managers accumulate and allocate an organisation's financial resources, a new conceptual framework is required for managing its capabilities, including its intellectual capital.

The measurement of an organisation’s reputation capability value is a fast-growing part of the knowledge management market. It has many attractions, at least in theory. The process of drawing up a Strategic Balance Sheet focuses managers on the capabilities enhanced by such tangible and intangible asset combinations. It also helps managers and investors to visualise the role of reputation assets in creating organisational value. These new measurement systems all use similar measures of human capital, customer relationships and structural capital, for example in the latter case, those embedded in organisational relationships and joint-ventures.

The paper argues that the capability of an organisation to govern itself adequately and protect itself against potential threats to its reputation requires informational measures that evaluate the impact of the actions of corporations on the environment, and on society. In the modern firm, therefore, Risk Management is very concerned with managing three "bottom lines", namely the capability of an organisation to maintain and enhance its reputation via its economic, environmental and social performance, and that this will ultimately lead to the maintenance and enhancement of its stakeholder value.

Once such new measures and reports are devised, there arises the need to audit them. Here as several more dimensions of the firm have to be audited or evaluated by accountors, not just the accuracy of the worth of the firm based on the past. That evaluation should also include the governance quality of the management. This paper highlights the importance of future oriented strategic auditing and how the various types of strategic audits have implications for attesting the strategic reputation-based capability values of the organisation as a going concern. Such accountors would not just be the legally-professional-mandated auditors but a body of persons trained to evaluate the future worth of the corporation.

Finally, it is argued that knowledge and information is of no incremental economic value unless it is used to *create value*. In today's globalised business environments such value is created by knowledge worker employees working in a shared ownership culture who understand the information that is presented to them and are motivated by this understanding. There is no doubt a risk manager must be up to the task of championing the new culture.

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