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Accounting Bulletin

Reputation rises on accountancy firms' risk agenda

Reputation is now cited regularly as a top risk in the annual reports, transparency reports and risk registers of accountancy firms as well as other professional services firms.

For the accounting profession, growth and trust are inextricably linked. Whilst brand impairment has always been a threat, accountancy firms, the clients they serve, regulators and capital markets, together, face several profound challenges including, but not limited to:

- the lingering economic uncertainty driven by geo-externalities and dislocations;
- the significant change in the regulatory environment;
- digital innovation and agility;
- ESG and societal obligations; and
- close public and activist scrutiny pursuant to widely reported corporate failures.

Reputation, or the "risk of other risks" (the aggregation of risks), has never been so valuable, or vulnerable. Bad news for accountancy firms is pervasive and should not be considered on a firm-centric basis, or even industry-centric basis; it is bad news for the profession, the business environment, capital markets and society. Collateral reputation damage may taint the profession at large.

The "risk of other risks" means reputation risk management is a fusion of:

- leading edge, agile, strategies;
- robust corporate governance;
- financial resilience;
- dynamic information protection planning;
- strategically embedded corporate, people, societal and environmental responsibility;
- energised and motivated human capital;
- transparent communications; and
- a pervasive code of conduct, ethics and values.

In the context of this paper, reputation is about the perceptions and beliefs, both past and present, which reside in the consciousness of a firm's stakeholders. It is not necessarily an accurate reflection of reality.

What is reputation?

The term "reputation" is often defined as the opinion that people have in general about someone or something based on past behaviour or character. In the context of this paper, reputation is about the perceptions and beliefs, both past and present, which reside in the consciousness of a firm's stakeholders. It is not necessarily an accurate reflection of reality. The veracity of the media is extremely influential in shaping perceptions and beliefs; it is the ether where perceptions are fashioned, distorted, and skewed almost instantaneously through global reach and real time media exchange mechanisms. We exist in a media-driven environment where brand is fragile. An organisation's reputation is not just what it says about itself, it is what others believe about it, its capability, its character.

Potential reputation vulnerabilities

Reputation risk per se is not a discrete risk category in the context of conventional risk taxonomy definitions, i.e. strategic, operational, financial or executional. The more accurate term is the risks to reputation, i.e. those risks, from whatever source, that can affect a firm's reputation, hence the predisposition to relate to "the risk of other risks".

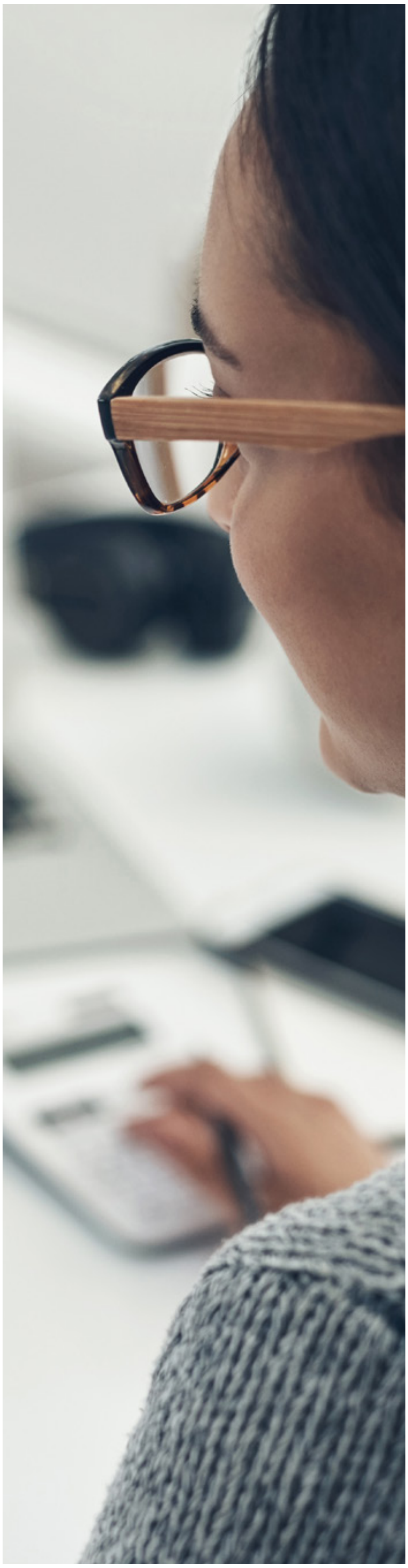
How might risks to reputation result in some, or even material, financial instability for an accountancy firm? Examples may include, but not be limited to:

- A significant piece of civil litigation or a regulatory investigation/ disciplinary tribunal.
- Service or delivery failure or lack of resilience in procurement and supply chains.
- Poor, inappropriate, discriminatory, or unethical conduct (bad actors).
- Failure to implement adequate quality controls and monitoring (audit quality, client acceptance and continuance, the engagement process, ethics & independence, fraud, money laundering and bribery).
- Failure to protect confidential client or sensitive personal data.
- Failure to prevent or recover from a cyber security breach/incident.
- Failure to respond appropriately to contentious societal or environmental (ESG) issues (commitments on decarbonisation, living wage standards, diversity pledges, etc.).
- Human rights, Health & Safety measures and well-being /mental health protections.
- Failure to comply with laws and regulations, or professional standards, or adapt to regulatory reform or identify, recognise, plan and deliver strategic and agile operational plans (inability to deliver competitive solutions or disrupt the disruptors).
- As applicable, network contagion (challenging integrity and trust by implication).

Potential implications

Management has a responsibility to protect stakeholder value, thus protecting the brand and reputation is equally important as promoting it. Any of the scenarios to the left could impact financial performance, impair confidence and trust amongst myriad stakeholder groups including employees, and drive/ enhance regulatory, public and activist pressure. The emotional power of brands is a determining factor in value creation.

A negative brand impact event for an accountancy firm could result in client defections and/or loss of prospective clients, the loss of business partners (alliances, vendors, suppliers or charitable foundations, sponsorships, or recruiters), recovery and resolution costs, a regulatory investigation and/ or civil proceedings, human capital flight risk, the inability to source contingent lines of credit (liquidity), and potential fines and penalties. In short, the erosion of trust - integrity, objectivity, professionalism, consistency, independence, and credibility.



The illustrational linear risks to the left should feature in an accounting firm's risk register, and a dynamic Enterprise Risk Management strategy will consider the multidimensional aspect, that is, what risks are affected by others, the interconnectivity of those risks and the strength of the connections, how fast an event may affect a firm (the velocity of impact), and potential transmissive, contagion or cluster risks. This is important in the context of reputation which is the risk of other risks. Organisational distress rarely originates from a single risk event but as a consequence of the interconnectivity of myriad risks, all of which ultimately converge into the broader threat to reputation. Firms should have resilience, recovery, and resolution plans with tried and tested phoenix strategies in place, focusing on the interaction of crisis management, business continuity, communication and disaster recovery policies designed to mitigate the impact on brand.

There are benefits to be derived from leveraging the opportunities and managing the threats associated with reputation including: customer loyalty; supplier, alliance and collaboration cooperation and sustainability; media and pressure group equity; robust regulatory engagement; costs of capital/credit; pricing (the ability to command a premium price); and quality people.

Challenges

Managing reputation is about two things: creating and protecting stakeholder value. Even with meticulous foresight and planning, events can be so unpredictable. Reputation loss travels rapidly and reputation, built up over many years, can evaporate or erode very quickly. Risks to reputation are likely to have soft origins or root causes and hard to quantify impacts.

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Whilst evolving tech-enabled AI solutions and parametric analyses will aid the quantification of reputation value, given the partnership or LLP structure of accountancy firms, assessing and quantifying the full economic impact of a loss is extremely challenging. This is compounded by other extraneous factors such as the effects of economic cycles and recessionary factors, the time lag associated with civil litigation or regulatory investigations against accounting firms, and exponential growth driven by demand for diversified services, products and solutions, particularly digital transformation.

Tailored insurance solutions

The foundation of insurance is indemnity; however, it is highly unlikely that insurance per se can put a firm in the same reputational position as it was in prior to a brand event. It can however, mitigate the impact.

As reputation is the risk of other risks, there is clearly a nexus between reputation risk and other classes of insurance such as professional indemnity, cyber, Directors' & Officers' / Management liability, and business interruption. The scope and breadth of these policies will vary but may provide for the indemnification of transactional costs of engaging experts to help the recovery and response process, as well as of an element for financial loss. Accordingly, Professional indemnity, cyber, Directors' & Officers' / Management liability and business interruption policies can, or could, provide support to firms where a reputation or brand is threatened. It is important to ensure said policies are sufficiently comprehensive and unambiguous, such that reputation costs can be recovered.

There are several stand-alone reputation insurance products that provide for response protection costs as well as revenue protection, the latter based on differing metrics and calculation methodologies.

The Lockton Global Professional and Financial Risk team is seeking to analyse reputational insurance in more depth and is working on developing tailored solutions that are both relevant and meaningful to accountancy firms, acknowledging, of course, the band-width variance based on firm size. It seems incongruous that reputation should feature so highly on the risk radar of accounting and other professional services firms, yet meaningful solutions remain elusive. There is no "one size fits all" solution, so a bespoke approach, tailored to a firm's needs, is required.

The first element of response protection costs should dovetail with the firm's own internal response capabilities. The scope, designed in consultation with the firm, might embrace costs associated with engaging public relations specialists, lawyers, Counsel; the costs of management time diverted from operational or client work; costs associated with any fundamental reorganisation of leadership or change in strategic direction/priorities; costs to prevent human capital flight risk, or costs incurred by the involvement of the International Organisation or Network (as applicable).

A scaled reputation product based on response protection costs, or a combination of response costs and revenue protection, will provide value, subject to relevant underwriting due diligence.

The second piece - revenue protection (impact on partner distribution) - is complicated. Bespoke solutions matching buyer needs with seller capability and appetite will need to address aspects such as structure, measurability, timing, and risks that are not the subject of cover. Recurring reputation fractures or a series of bad business judgements should be capable of absorption in the balance sheet, so the structure should evolve around scenarios, trigger and perils, that are likely to create severe reputation damage and require substantive repair to the balance sheet.

As an emerging, non-conventional, risk, reputation might be considered as a new line of business to be underwritten via a captive (as applicable). A scaled reputation product based on response protection costs, or a combination of response costs and revenue protection, will provide value, subject to relevant underwriting due diligence. “Reputation event” can be broadly defined in line with the firm’s strategic business objectives to optimise value to the firm. As this line matures over time, conventional reinsurance might be available to mitigate the impact on capital and liquidity.

The principal challenge is the linkage between causation, triggers and damages over a period of time.

However, we believe that bespoke, responsive, insurance solutions can be designed to meet a professional service firm’s specific need.

Further investment in workable solutions and analysis is required.

We would encourage and welcome both your feedback and engagement on this topic to better understand the needs of the buying community in this particular space.

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