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MANAGEMENT ACCOUNTING GUIDELINE

Integrating Social and Political Risk Into Management Decision-Making

By

Tamara Bekefi

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Marc J. Epstein

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INTEGRATING SOCIAL AND POLITICAL RISK INTO MANAGEMENT DECISION-MAKING

INTRODUCTION

The corporate risk landscape has shifted significantly in recent years. Larger and more varied risks than ever previously thought have been seen in companies and countries who had believed they were immune from those risks. Rapidly increasing globalization poses a common challenge—how to integrate the social and political risks of government instability, political corruption, business corruption, child labor practices, anti-corporate sentiment, terrorism, environmental pollution, and others, into management decisions. To date, no adequate methodology for integrating these issues into risk management has been found.

Developing and implementing an appropriate model for decision-making and measurement of social and political risks is critical for improving organizational performance by more effectively (a) anticipating, evaluating, preparing for, and mitigating risks, and (b) managing alternatives. To effectively manage risk and improve the resource allocation process, risks must be measured and integrated into ROI calculations.

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EXECUTIVE SUMMARY

Today risks are both larger and more varied than ever previously thought. They are far broader and have been seen in companies and countries that thought they were shielded. With globalization increasing rapidly, a common challenge is how to integrate social and political risks of political instability, political corruption, business corruption, child labor practices, anti-corporate sentiment, terrorism, environmental pollution, and so forth into management decisions.

This publication building on the model developed in the Management Accounting Guideline "Identifying, Measuring, and Managing Organizational Risk for Improved Performance" provides the tools, techniques, and specificity needed to aid managers to more effectively integrate social and political risks into their decision making processes.

These calculations can be applied to day-to-day operational decisions and capital investment planning, such as choices about plant location. Robust decisions under both circumstances are predicated on sound identification of risks, their assessment, and their mitigation and avoidance. We know, for example, that a wide array of political and social issues in both the developed and developing world can often cause a major impact on profits in an organization's home country. These risks affect all types of organizations, including for-profit, non-profit, global, domestic, and large and small enterprises.

Generally, risk can be described as any event or action that will adversely affect an organization's ability to achieve its business objectives and successfully execute its strategies. Risk relates to the probability that exposure to a hazard will have negative consequences. Social risk relates to the potential impact of, for example, disease, damage to the environment, infringement of the rights of indigenous peoples, and challenges by stakeholders due to negative perceptions of business practices—all of which can jeopardize a company's value. Political risk can generally be understood as execution of political power that threatens a company's value. The distinction between social and political risk is, however, often blurred, and different sectors in varied locations can be affected differently by either kind of risk.

Societal perceptions of the connections between a company and particular social and political risks can cause enormous costs to companies, regardless of the company's direct involvement in the issue. Whether society is reacting to a real or perceived risk, it may take action, including consumer boycotts, leading to loss of sales or increased regulation that negatively affect a company, whether by (a) increasing its costs, or (b) prejudicing its achievement of business objectives or its ability to carry out its strategies. [*Note that I have brought in language similar to that used in defining risk earlier.*]. Thus, managing these types of risks is critical, whether they are real or perceived. (For further discussion of real and perceived risks, see Appendix 1.)

Public perception of companies has proven to be an important component of risk. Research following anti-World Trade Organization protests in Seattle showed that investors drove down the market capitalization of companies without a reputation for corporate responsibility on average by $378 million per company, but did not penalize firms reputed to be socially responsible. (Schneitz and Epstein, 2004). This demonstrates the significant positive financial impact of a reputation for managing social and political risks well.

[*The now deleted sentence doesn't identify who is concerned. I altered the second sentence.*] Companies must more clearly recognize the importance of (a) integrating a broader set of risks into management decisions, and (b) developing expertise in measuring the impact of social and political issues on financial performance. This clearer recognition requires managers to include measurement of social and political risks in ROI calculations. Currently, companies that do consider these issues often relegate them to a footnote in the reporting of investment decision and do not include them in calculating ROI. That effectively gives a zero valuation to risks that can negatively affect corporate earnings, shareholder value, and brand value.

Some businesses are prone to social and political risk because of the location of their facilities, their product and customer characteristics, the nature of their employment relationships, or industry characteristics, etc. Well-known examples include Nike, Wal-Mart, and Shell, as well as the notorious social risks associated with industries like mining, footwear, apparel, toys, and chemicals. Also, varying social and political risks, and degrees of risk, affect companies located in specific countries or regions of the world. More globally, devastating terrorism attacks such as September 11, 2001 have dramatically increased risk, resulting not only in a terrible impact on individuals and government, but also an overwhelming impact on businesses. Corporations hoping to properly manage risk require more analysis, evaluation, preparation, mitigation, and response planning.

This Guideline, aimed at CEOs, CFOs, and other top managers, provides a model for identifying and measuring social and political risk, and including these risks in ROI calculations, to create a more robust enterprise risk management (ERM) system. This modeling forms one small part of ERM, simply by including previously ignored risks.

BACKGROUND

In a recent Management Accounting Guideline ("Identifying, Measuring, and Managing Organizational Risk for Improved

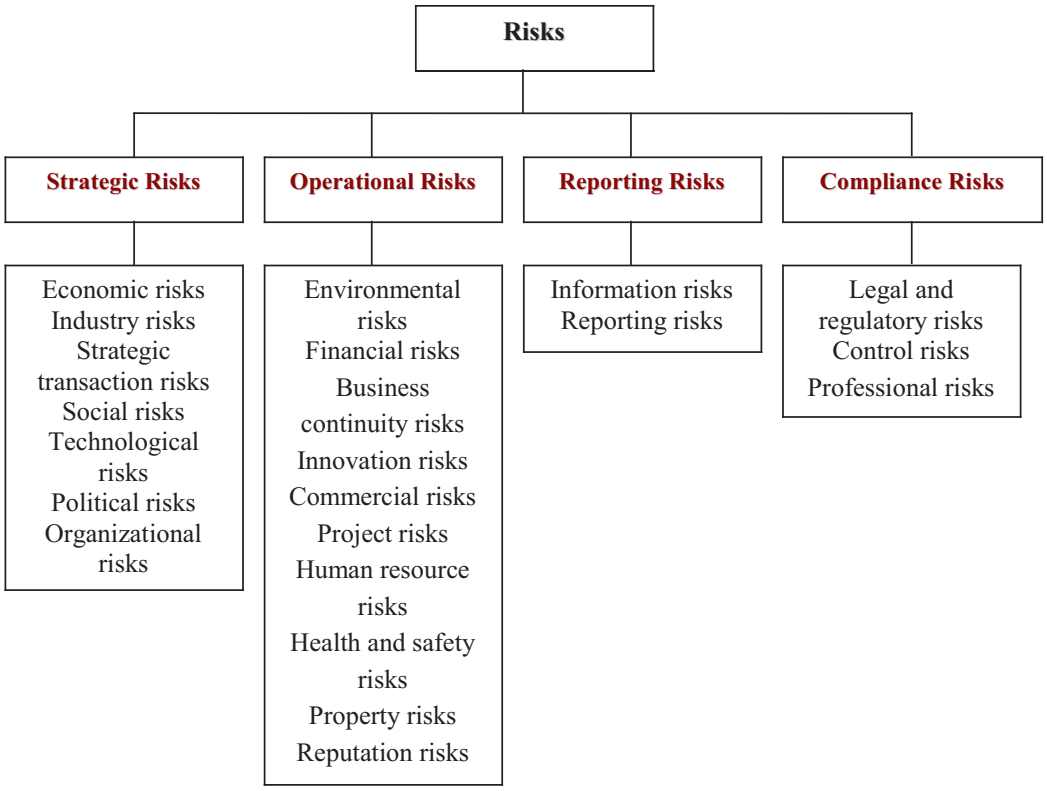
Performance"), Marc J. Epstein and Adriana Rejc developed a model and measures for improving the identification and measurement of risks to improve management decisions. It built on newly created requirements for the assessment of risk of the Sarbanes-Oxley Act of 2002 in the U.S., and similar new regulations in other countries. It also built on work by the Committee of Sponsoring Organizations (COSO) of the Treadway Commission and the recently issued Enterprise Risk Management Framework, by further specifying the necessary tools for identifying and measuring a broad set of organizational risks. More importantly, though, it focused on improving the quality and effectiveness of both operational and capital investment decisions, through more effective management of organizational risk.

Epstein and Rejc demonstrated that increased measurement of a broader set of risks is necessary, both to meet recent regulatory requirements and to improve managerial performance and stakeholder confidence. They provided a risk assessment model, illustrated in Exhibit 1, which builds on the 2004 COSO *Enterprise Risk Management—Integrated Framework*, and provides a scheme that classifies risk into four broad categories—strategic, operational, reporting, and compliance.

- *Strategic risks* relate to an organization's choice of strategies to achieve its objectives.
- *Operational risks* relate to (a) threats from ineffective or inefficient business processes for acquiring, financing, transforming, and marketing goods and services, and (b) threats of loss of firm assets, including its reputation.
- *Reporting risks* relate to the reliability, accuracy, and timeliness of information systems, and to reliability or completeness of information for either internal or external decision-making.
- *Compliance risks* address the inadequate communication of (a) laws and regulations, (b) internal behavior codes and contract requirements, and (c) information about failure of management, employees, or trading partners to comply with applicable laws, regulations, contracts, and expected behaviors (Epstein and Rejc, 2005).

Their risk assessment model serves as a basis for the following discussion of social and political risk, which falls predominantly in the strategic and operational segments of the Epstein and Rejc classification. This Guideline builds on the previous guideline by Epstein and Rejc, providing needed tools and techniques so that managers can more effectively integrate social and political risks into their decision-making. It will illustrate

Exhibit 1: Risk Classification Scheme



why it is important for companies to understand social and political risk, and how to measure it for more effective risk management.

Although identifying and classifying risks are critical first steps, it is essential to management practices that their impacts on the firm be measured. The previous guideline emphasizes the importance of assessing risks, both in terms of their cost if they materialize, and the benefits flowing from appropriate risk response. Of particular relevance to understanding, measuring, and managing social and political risk is the capability to quantify their potential impacts.

We build on the previous guideline by describing how companies can more effectively integrate social and political risks into operational and capital investment decisions, including how to identify and measure them. The enhanced model also provides specific guidance that permits ROI calculations to include a formal and explicit assessment of these risks. This assessment will improve resource allocation decisions and risk management, both of which are the responsibility of senior corporate managers and boards of directors.

CURRENT PRACTICES IN IDENTIFYING AND MEASURING SOCIAL AND POLITICAL RISK

Companies face complex political and social challenges. They are wide-ranging and have different impacts on organizations, depending on sector, geographic location, and type of operation. Further, consideration of risk is substantively different if a company is considering opening a new venture or tackling challenges to existing operations. Previously, corporate risk was more narrowly focused on internal financial controls and corporate frauds. Now, identifying, measuring and seeking preventive or mitigation strategies to address social and political issues have become crucial to firms functioning in various countries. All companies are struggling to make business decisions that integrate financial information with insight into social and political concerns that can seriously affect their projects and bottom lines. Integration of social and political risks into the financial equation has, however, remained a challenge.

Qualitative Approaches

Techniques to evaluate and communicate political risk have been emerging since the mid-1970s, when multinational firms, particularly in the extractives and banking industries, built in-house teams employing political scientists and former CIA and U.S. State Department personnel. These teams looked at risk assessment qualitatively, producing detailed local briefings that outlined challenges in various locations. While providing sound insight into political instability and risks, these local briefings did not capture the cost of risk, because they failed to connect the issues to the business or explain their potential negative impact. For this reason, the briefings did not enable executive decision-makers to integrate these insights into business assessments. In fact, important information contained within those briefings was sometimes relegated to a footnote in the decision-making process.

Quantitative Approach

From the qualitative model emerged efforts to quantify political risk, to make it more relevant to corporate management. To accomplish this, various methods were developed.

- ***Scorecards:*** Indicators of potential political and social risks, such as judiciary independence, corruption, and government turnover, were evaluated and assigned a numerical score. For example, a government viewed as highly corrupt could be assigned a 10 in a possible scale of 1-10. Then, depending on the methodology, the scores from these indicators were aggregated or the statistics were analyzed to generate a final measure that reflected the political risk of a country. An indicator listing that looks specifically at corruption, Transparency International, ranks the world's countries on the basis of perceived levels of corruption. Another political risk consulting firm divides its indicators into four subcategories—government, society, security, and the economy—first calculating ratings for each subject, then aggregating them to create a national stability rating that can range from 'failed states' to 'maximum stability'. Such scoring is helpful, because it enables a comparison between countries. It falls short, however, of being directly useful to business decision-making, because the risks are not converted into monetary terms. (See Appendix 2 for a listing of companies that provide such data).
- ***Statistical analysis:*** Probability analysis requires risk personnel to identify probable

issues and quantify them. Staff considers each risk and assigns a rating of high, medium, or low, and expected values, as well as a corresponding probability for an occurrence, all probabilities associated with a single risk equaling one. The data is then loaded into a spreadsheet application, such as Crystal Ball, which uses Monte Carlo simulations. Crystal Ball is an analytical tool that automatically generates equations to capture uncertainty, such as the cost of a coup to the company. It uses the Monte Carlo simulation model, which mimics the random chance of casino games, generating values for variables that have a known range of values, but an uncertain value for a particular time or event. Hundreds or even thousands of simulations can be run in a matter of minutes, and forecasts are generated for each point in the pre-determined range (high, medium, low) of risk. The results show project managers either the most sensitive issues on which to concentrate—sensitivity analysis—or a cumulative probability curve indicating the potential economic performance of a project—based on a pre-constructed decision tree that indicates key decisions and uncertainties. Although this methodology involves quantification and the consideration of potential risk impacts, the outputs of these calculations, which include charts, graphs, and dynamic models, cannot be integrated into financial evaluations. This is because they do not generate an ROI number, a political/social risk beta, or any monetary results that can be included into financial calculations.

- ***Scenario-based methods:*** Risk mapping is one method popular with corporations. This method plots the expected frequency, severity and degree of exposure of various risks on a graph, with probable frequency on the horizontal axis and expected severity on the vertical axis. (Birbeck, 1999). Calculations are made according to the following formula:

  Exposure = (event) x (hypothetical likelihood) x (hypothetical consequence)

  The benefit of such modeling is that it allows measurement of various types of risk, and enables managers to visualize where to allocate resources for risk management. In addition, mapping is a valuable communication tool, providing a comprehensible visual review of exposures, though they are not usually expressed in monetary terms. For this reason, mapping as currently practiced does not provide a link to the financial statement, or to the ROI calculation that is critical for comparisons between possible project options. With some modification, including assignment of monetary values to the hypothetical consequences, however, axis points on such a risk map could correlate to financial data and be integrated into ROI calculations.

- ***Adjusted Discount Rate & Cost of Capital:*** One method of integrating social and political risks issues into financial modeling is the inclusion of social and political risk in a discount rate or cost of capital calculation that flows into cash flow calculations. This can be done by creating a *social discount rate* that employs the weighted average cost of capital (WACC) and the traditional capital asset pricing model (CAPM). This is done in three steps:

  1. calculate the cost of equity;
  2. develop the risk-free rate (RF) by assigning the long-term government bond rate;
  3. develop a risk-adjusted "beta", based on the difference between the return earned by investors in an industry and the average return earned by investors in the market as a whole.

When dealing with markets that may exhibit hallmarks of social and political risk, this adjusted WACC accounts for social and political factors.

However, this method is difficult to implement. To date, the calculations for a risk-adjusted beta have relied largely on the standard country risk ratings methodology generated by political risk consulting firms (see Appendix 2 for more detail on these firms). Although useful as a theoretical methodology, such point-based risk ratings as the basis for beta calculations are too broad to achieve the needed objectives. These ratings are neither industry-, project-, nor company-specific, though social and political risks affect companies and their reputations differently, even if they operate in the same country. To be really useful as a basis for a social/political risk beta, the country risk ratings generated by political risk assessment firms require customization to particular companies, locations, and projects.

We therefore propose another method to quantify social and political risk for inclusion in financial calculations, one that includes integrating the costs and probabilities of each social and political risk, and calculating an expected value.

Observations

In a recent survey of risk management executives, more than 60% of respondents anticipated a continuation of "significant external risk" in the

next five years, based on recent historical events (The Conference Board and Mercer Oliver Wyman). According to a McKinsey global survey of business executives,

- Only 3% of the 4,238 executives who responded to a poll reported that their companies were doing a good job of anticipating risk.
- 46% of respondents said they have "substantial room for improvement."

This growing recognition of the need to better integrate insight into how social and political issues may affect the firm necessitates an adequate methodology to quantify these issues in a way that supports effective management decision-making.

Given the lack of such a methodology to date, most companies largely make capital investment decisions and operational choices with a primary focus on financial risk, as it is most narrowly defined. As a result, they fail to make a more comprehensive calculation that could substantially affect decision-making and corporate financial performance. Currently, there is a tendency to separately treat financial risk, which has traditionally been measured, and social and political risk, which has historically been analyzed qualitatively, and now more recently quantitatively, to produce weighted risk indicators and maps. In cases where these issues have been considered, they have often been relegated to an addendum to the investment decisions process and are not included in the calculation of ROI. This places a zero dollar value on potential risks that can damage profits. As a result, operational and other decisions are often based on quantified financial factors, simply for methodological reasons, leaving key issues, which may have dramatically negative impacts on ROI, unaccounted for.

Many components of risk must be included in a comprehensive risk assessment. Although measuring some of them is only possible through estimating rather than exact calculation, all risks can be quantified to some extent. If they are not then included in financial calculations, the company will often inadequately integrate these risks into management decisions and simply gamble that they will not emerge. Discussing the importance of these risks and their potential impact is not intended to inhibit investments. Rather, including these risks in calculations aims at creating more informed decisions. The very act of deciding on a number (or a range) to include in calculations means that decision-makers are discussing these issues and their importance. There is, however, a danger of declining to invest because hurdle rates were not met due to inclusion of social and political risks, without senior management ever being aware of it. Therefore, it is critical to share the thinking and decisions made in assigning risk values. This is discussed more fully in a later section.

Further, without fully understanding some of the complex risks facing the business, (a) decision-makers may not include pre-emptive measures into project planning and execution, and (b) opportunities for growth and profit from day-to-day operations may be lost.

INTEGRATING SOCIAL AND POLITICAL RISKS INTO GENERAL RISK MANAGEMENT

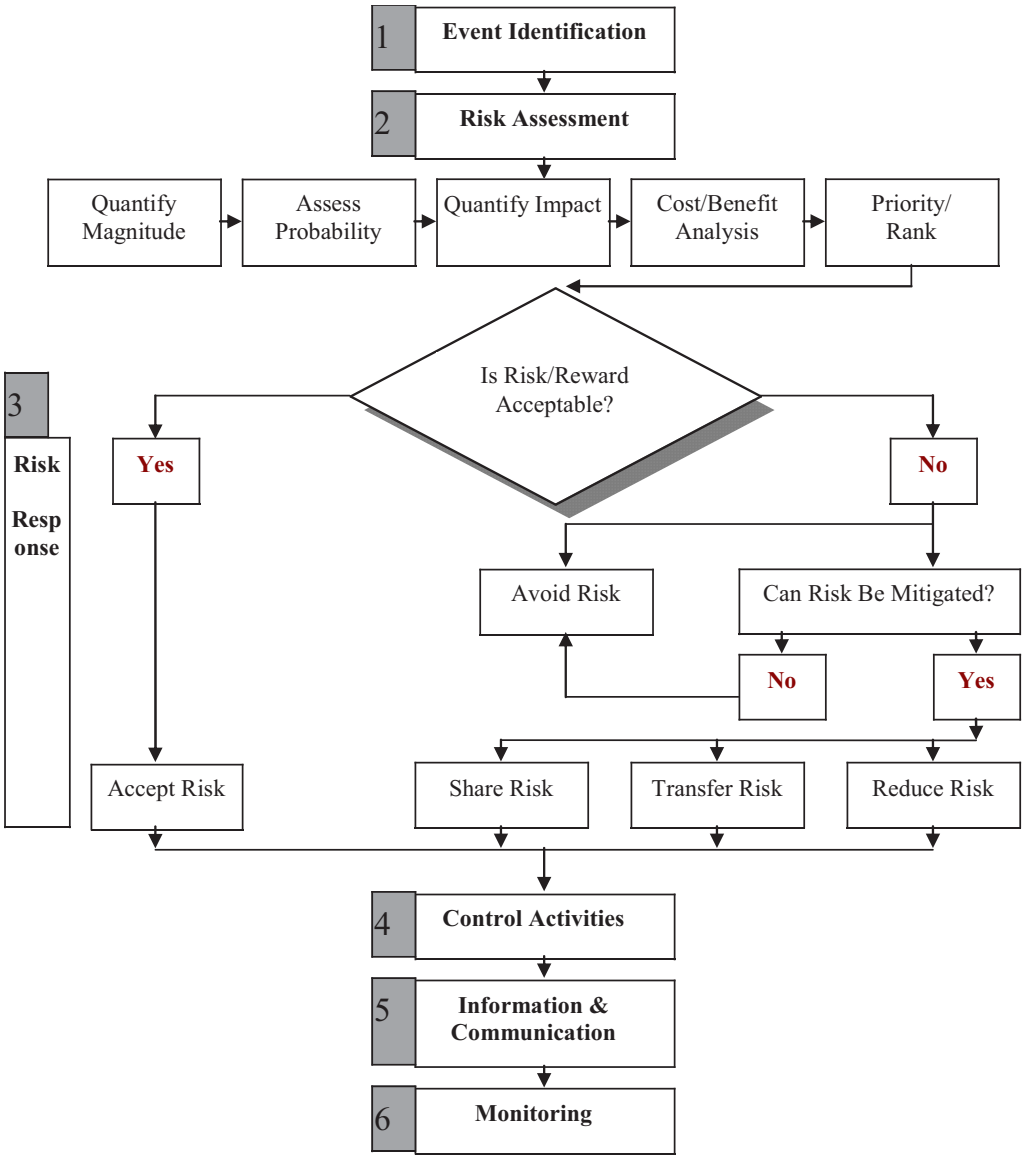
To manage risk effectively requires:

- comprehending the socio-political and corporate environments that might affect risk;
- identifying risks;
- evaluating and measuring their potential effects;
- identifying and analyzing possible solutions;
- adopting the most appropriate risk management actions;
- communicating results; and
- monitoring evolving risks.

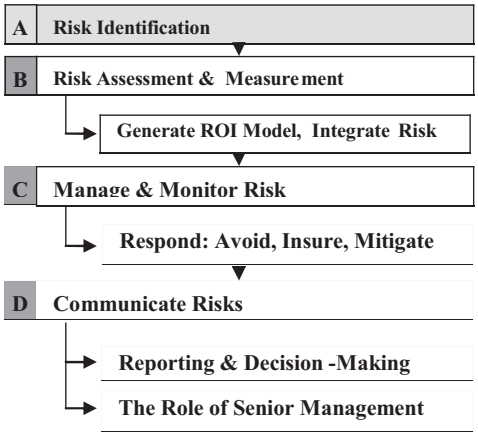
In this section, we build on and modify the Risk Management Process model provided in the 2005 Management Accounting Guideline[1] (Exhibit 2), by including social and political risk, and offering additional tools and techniques to enable companies to integrate these new risks into management decisions.

1. Epstein, Marc J. and Adriana Rejc Buhovac. *Identifying, Measuring, and Managing Organizational Risk for Improved Performance*. Risk Management Accounting Guideline. CMA Canada and AICPA. 2005.

Exhibit 2: Risk Management Process



I. RISK IDENTIFICATION



Complex social and political issues often affect company operations. Identifying risks that can affect company value as the first step in measuring and managing political and social risk is therefore important.

Social Risk

Many social issues can affect a company doing business nationally and internationally, whether in developing or developed countries. Some industries are more prone to these risks than are others. For example, businesses with big installations like factories, ports, mines, and refineries can lead to dissatisfaction and unrest in a local population when:

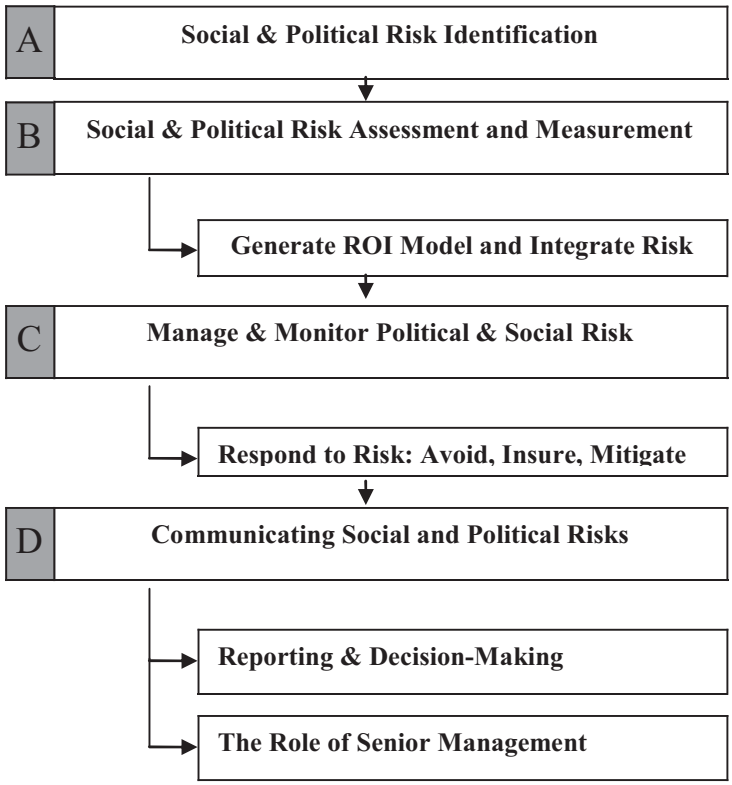
- there is the perception that local expectations are not being met;
- the surrounding area is being polluted; or
- business is undertaken in a region of general political unrest, where the military is protecting a site and using its presence to harass the local population for reasons unrelated to the business. The local population can sometimes associate the company with these practices, and begin to target it as a proxy for the government or the military.

The experience of US-based Freeport McMoran, which owns a large gold and copper mine in Papua, Indonesia, is a case in point. The company lost approximately $48 million and 20% of its share price[2] due to clashes with the populations surrounding the Freeport mine. Tension had already mounted in the region because of a December, 2005 *New York Times* report that Freeport, which employs 180,000 people and is one of Indonesia's largest taxpayers, had paid Indonesian military and police officers close to $20 million between 1998 and 2004, leading to an investigation by the U.S. government and protests by the local population.[3]

Further ill-will brewed when poor residents near the Freeport mine, with few economic opportunities, began prospecting for gold in the waste rock from the company's operations. Citing possible health concerns from exposure to this material, the company moved to prohibit prospecting, positioning private security guards around the mine, who allegedly had authority to shoot at prospectors. The local community, however, was suspicious of the cited health reasons, as it already perceived that a large foreign company was making huge profits from

In Exhibit 3, we illustrate how companies can include social and political risk into overall risk management. We include the detailed steps and analysis necessary to identify and assess political and social risk in a manner that is relevant to financial decision-making.

Exhibit 3: Social and Political Risk Integration Model



2. Pan, Esther. "Small Window for Peace in Papua," *Council on Foreign Relations*. April 19, 2006. http://www.cfr.org/publication/10484/small_window_for_peace_in_papua.html

3. Seelye, Katharine Q. "Indonesia: Mining Company Notes U.S. Review of Payments to Indonesian Military," *The New York Times*. January 19th, 2006.

use of its land. Impoverished local residents believed that they were being unjustly prevented from sharing, even marginally, in the big company's wealth. In reaction, the community began protests that closed the mine for four days—at an approximate cost of $12 million a day.

Nigeria presents another example of risks that can emerge on the arrival of a large company to a relatively isolated or under-developed area. The arrival of petroleum companies created unintended consequences when a sudden influx of people, mostly unskilled, began looking for work at the oil installation. When no jobs were available, some turned to violent behavior. A number of unemployed Nigerian youths began attacking oil pipelines, taking personnel hostage, and in one case, seizing an offshore oil rig, demanding that they be given jobs.[4]

A further potential unintended long-term consequence of new operations is the focus of the local economy exclusively on one industry over a long period of time, resulting in dependence on one company, operation, or industry sector. When the company leaves or the industry is no longer viable, the surrounding area is usually economically devastated, creating a potential backlash against the company by local populations. This has happened frequently in company towns in the U.S. and abroad, in industries ranging from steel milling to coal mining. For example, Detroit, Michigan saw a tremendous dip in its standard of living when the automotive industry became less competitive. Some industries are less prone to these risks, but it is critical that companies that must or choose to remain in one location for the long-term, understand and mitigate these risks. In many cases, mitigation calls for both an effective community relations strategy, as well as an exit strategy that deals with both environmental and economic issues to diminish negative consequences. Risk mitigation is discussed in a later section.

Health, safety, and environmental issues affect all companies. Recently, debate has begun on regulating emissions at major U.S. ports. This would create additional unexpected costs for both freight companies and importers and exporters of goods from places like the Ports of Los Angeles and Long Beach.

Companies working internationally face often costly worker and community health issues for a variety of reasons, including lack of adequate medical care in certain regions of the world. HIV infection has become a particular risk for companies in the extractive and transportation sectors, both heavily male-dominated, where operations attract increased prostitution. This increased level of HIV infection of workers can quickly lead to sickness and eventual death. Left unchecked, this trend will expose companies that have trained workers and rely on their skills for production to additional costs. Road accidents, a killer that will eclipse both AIDS and war by 2020 according to the World Health Organization, also represent a tremendous cost to companies reliant on long-haul trucking. 80% of total road deaths occur in developing countries, often resulting from overcrowded vehicles and an unsafe mix of animals, people and vehicles on the road. Statistically, companies that rely on roads in these parts of the world will be exposed to loss of their drivers or cargo due to unsafe road conditions. Some companies try to mitigate this risk by training their own staff and contract drivers, as well as working with other companies and multilateral organizations to address road safety.[5]

Using labor forces—like children and forced labor—that certain societies consider unacceptable can put companies at risk. In some areas of the world it is customary that children work, and this is one of the better options available to them. However, use of child labor has led to product boycotts by customers opposed to the practice and terrible publicity. The use of forced labor, a practice that has been exposed in the supply chain of some companies, can also create great problems, even if the company did not directly employ this labor. In 1996, activists and Burmese villagers filed a lawsuit against Unocal under the Alien Tort Claims Act (ATCA). The ATCA grants to a U.S. federal court jurisdiction over a claim, when a non-U.S. citizen or alien sues for a tort committed in violation of a United States treaty or other international law. In this ATCA case, Unocal was accused of (a) complicity in the Burmese military's use of forced labor to build the Yadana pipeline, of which Unocal was a junior partner, and (b) allowing Burmese

4. "Nigerian oil fuels Delta conflict," *BBC*, January 16, 2006.

5. Bekefi, Tamara. *The Global Road Safety Partnership and Lessons in Multisectoral Collaboration*: Corporate Social Responsibility Initiative, Kennedy School of Government, Report # 1—August 2005.

troops guarding the project to rape, murder, and enslave villagers. The company denied any part in these human rights abuses, but settled the suit for an undisclosed amount of money in 2004.[6]

All of these social issues emerged as risks to companies, and some risks took companies by surprise and came at a great cost. The largest of these costs, lost sales and profits, often results from damage to reputation. Other risks that present a potential monetary liability seem poised on the horizon. One example is climate change, which may present a potential future monetary liability. Although there is still debate on climate change and liability is not a certainty, its likelihood warrants some companies to consider it by factoring it into decision-making.

Political Risk

Generally, political risk can be understood as execution of political power in a way that threatens a company's value. Two types of political risk are relevant to companies doing business internationally: industry- or firm-specific political risk and country-specific political risk. On the one hand mass anti-government protests, then, may not pose a political risk to a firm if they do not affect (a) government policies towards business, or (b) the firm's current or future operations or value. On the other hand, changes in the legal framework governing contracts could have a significant negative impact on the company. Industry- and firm-specific political risk is experienced by one industry or firm, such as threats by Bolivia's President Evo Morales to nationalize the country's oil and gas sector. Companies including Brazil's Petrobras and Spain's Repsol YPF have invested $3.5 billion into developing Bolivia's natural gas fields, the second-largest natural gas reserves in South America.[7] Morales' threats have recently been translated into specific actions against foreign energy companies, beginning with (a) forced audits of their financial documentation, and (b) the demand to renegotiate concession agreements and revenue-sharing from gas field development to give the government a majority stake within six months.

Sector-, provincial-, and country-specific political risk is spread more widely. These risks can include a civil war, drastic changes in foreign currency rules, or sweeping changes to the tax code. These types of risks can be generated directly from the host country government, or emerge from an unstable social situation within the country. Regardless of the source, a company attempting to understand potential political risk must recognize the difference between (a) political issues that can affect corporate performance, and (b) dramatic situations that have no financial impact on the company. In addition, companies should understand the potential reputation damage, and associated costs, related to political risk.

The distinction between social and political risks is often blurred. We consider these issues to fall along a continuum, as illustrated in Exhibit 4. The subjects in Exhibit 4 are only some of the most critical social and political risks facing global companies today. Although the Exhibit does not try to list all risks, the wide variety of risks it includes provides a sample of relevant issues facing companies. Each organization should generate its own list of social and political risks, based on their relevance to its business(es) and the business environments in which it/they operate(s).

6. David Baker. "Purchase of Unocal by Chevron Deal puts new sources of gas and crude in the right places for East Bay oil giant," *San Francisco Chronicle*. Tuesday, April 5, 2005.

7. *The Economist*, December 2005.

Exhibit 4: The Social-Political Risk Continuum

Developing a Risk Profile

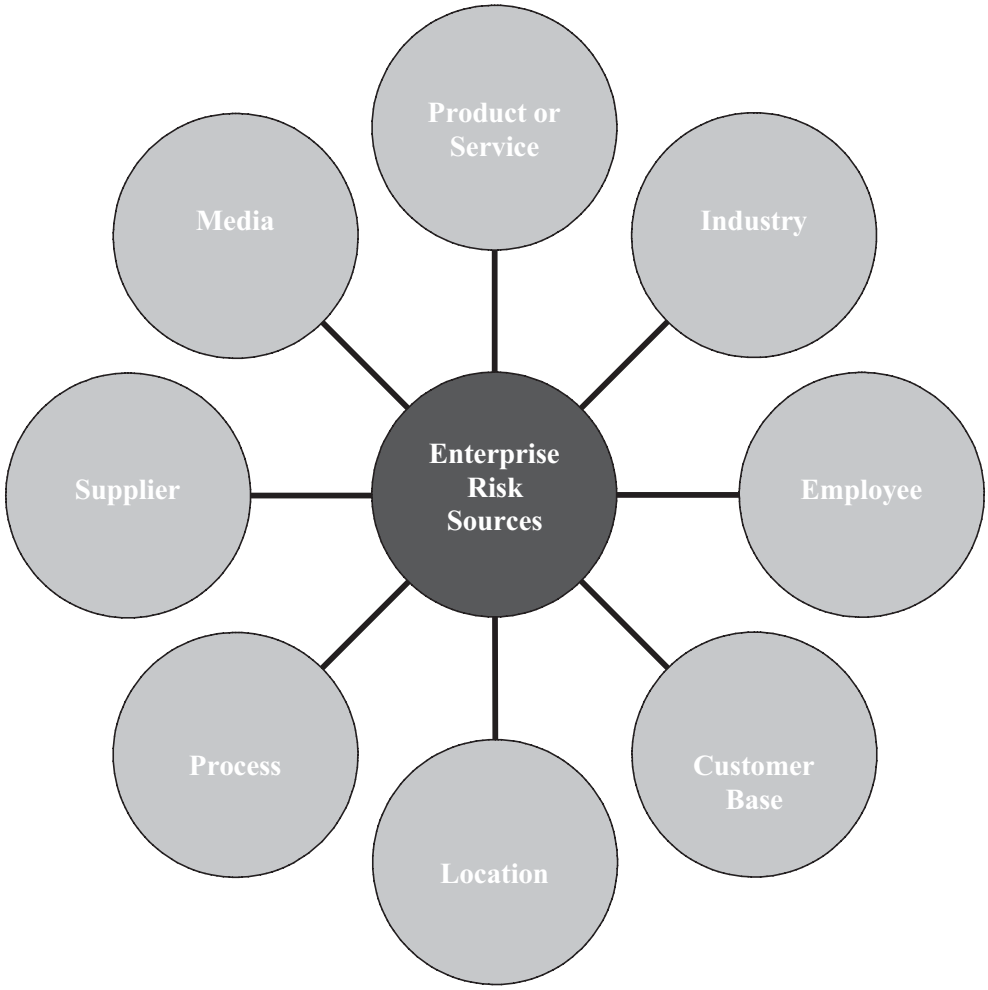
To effectively manage social and political risks means, first and foremost, being able to identify risks that face the firm from various sources, and handle them within a larger risk management framework. This allows decision-makers to develop a situation or project-specific risk profile that will help to (a) reduce unwanted surprises, (b) minimize the negative effects of external factors on the business, and (c) maximize the potential for solutions. Developing a risk profile has two elements:

1) Identify enterprise risk sources
2) Identify company- or project- relevant social and political risks

Element 1: Identify Enterprise Risk Sources

When developing a situation- or project-specific risk profile that includes social and political

Exhibit 5: Enterprise Social & Political Risk Sources



issues, it is critical to be aware that these issues are experienced quite differently, depending on a firm's sector, industry characteristics, product(s), customers, geographic location(s), and employment. Identifying the sources of risks is also helpful for the following reasons:

- Identification helps refine the list of issues that could affect one's company,
- Response strategies will be more effective if the sources of risk are known, permitting managers to address the issues at their source.

Exhibit 5 illustrates some of the sources of risk that may help to formulate a risk profile.

Companies in different sectors can face significantly different risks, as well as attracting different outside scrutiny on diverse issues. The risks that emerge from such scrutiny have affected companies, and in many of the first cases, companies were surprised to be accused of socially unacceptable behaviors:

- The oil, gas, diamond, and gold industries have been accused of adverse environmental impacts, human rights abuses, negative effects on local communities, and sometimes of colluding with corrupt governments in developing countries. These industries also face issues simply because of their operating environments. An extractive company may undertake new operations in countries with unstable political environments where corruption may be rampant; the judiciary may be too weak to enforce contracts; and infectious disease may wreak havoc on skilled labor. These challenges would likely not emerge if the company were beginning a project in North America. Extractive companies may be forced to operate in an unstable environment, as they must go where

the product is found. Companies in other sectors are often not so limited. Companies having or choosing to operate in higher risk environments must identify these risks as a first step in evaluating and managing them. DeBeers, which operates in regions where the incidence of HIV/AIDS is the highest in the world, calculates that 10% of its employees were likely infected with HIV and that a program to treat its infected employees would cost the company US$1,200-US$3,500 per worker annually for 10-14 years. DeBeers considered this a cost-effective approach compared to its other two choices: (a) the cost of losing HIV-infected workers to AIDS-related illness and death requiring the hiring and training of new workers, or (b) the cost and inefficiency of hiring and training three workers for each job, to prepare for AIDS-related losses. DeBeers is currently implementing an HIV/AIDS employee education and treatment program.[8]

- Footwear and clothing production have been associated with low wages, child labor, and unfair working conditions. Companies with manufacturing operations in developing countries, and thus faced with non-Western labor practices in areas such as wages, overtime, and child labor, find that these practices are often scrutinized by the media or the companies' customers both of whom are sensitive to these practices.
  - Nike was accused of employing children as young as ten years old in Cambodia and Pakistan to produce sneakers, clothing, and footballs, leading to consumer boycotts. These consumers did not differentiate between the company and its subcontractors.
  - In 1997, Kathy Lee Gifford's clothing line came under attack when the news media broke a story alleging that the television star's clothing line was being manufactured by Honduran women and girls as young as 12, who were working in dreadful conditions.
  - In September 2005, a class action lawsuit was filed against Wal-Mart on behalf of workers in Bangladesh, Swaziland, Indonesia, China, and Nicaragua. The lawsuit alleged that the world's largest retailer had failed to monitor working conditions in its supply chain, and that its demand for low prices forces suppliers to enforce sweatshop conditions.
- A computer chip manufacturer might struggle with stakeholder reactions to chemical use and its impacts on the local environment. These business-to-business industries are often affected less by damage to reputation related to social and political issues than are companies in other sectors.
- Telecommunications firms may face negative reactions by its customers over use of their personal information and records of their use of the telephone or Internet. Refusing to share such information, however, may present other risks. Recently, news has emerged that the U.S. National Security Agency (NSA) has been secretly collecting the telephone records of millions of Americans by agreement with AT&T, Verizon, and BellSouth. When QWEST, a fourth company, declined to participate, the NSA threatened negative consequence in government dealings for failure to cooperate.[9]
- Prescription drugs and their producers have been linked to developing countries' lack of access to essential medicines. HIV/AIDS drug producers were boycotted because they would not lower product prices in South Africa.
- Food and beverage companies have been associated with the obesity epidemic; McDonald's has been accused of encouraging obesity through marketing its products.

The obesity-related lawsuit against McDonald's was revived in January 2005, and has led to more general changes in both production and marketing practices of the food industry. McDonald's began to offer salads and fruits in addition to the traditional hamburgers and French fries, and PepsiCo's Frito-Lay snack unit replaced trans-fats with corn oil in its products at a cost of $57 million, and began producing reduced-fat Lay's potato chips and Cheetos.[10] The threat of legal liability could reach as far as local supermarkets and convenience stores, since recent studies have found that products in stores

8. Global Business Coalition on HIV/AIDS <www.businessfightsaids.org>

9. Cauley, Lesley. "NSA has massive database of Americans' phone calls." *USA Today* May 11, 2006.

10. "Food Giants Scramble to Avoid Lawsuits." *The Agribusiness Examiner*, August 30, 2004. http://www.organicconsumers.org/school/obesitylawsuits083004.cfm

located in the poor neighborhoods of North America offer more convenience (junk) food and few fresh fruits, and hardly any vegetables.[11] Some convenience store chains like 7-Eleven are responding by offering organic and healthier snacks to consumers.

Companies beginning to identify social and political risks that may affect them or their products must understand the setting for their businesses, and how that setting might generate risks. This process need not necessarily be costly and time-consuming, though the degree of investment in risk identification would likely depend on the size and importance of the company or project.

Risk may emerge simply from:

- ***Operating Location***: Locating a plant in Myanmar, where a totalitarian military government is known to encourage the use of forced labor, will likely pose more risks than doing business in Singapore, where this is not a common practice. Likewise, opening a pub near a school may generate protests from the local community.
- ***Reaction of society or a group of people affected by, or who believe they will be affected by, business activities***: In Peru's Cajamarca region, Newmont Mining has been grappling with the local community's dissatisfaction and its sometimes violent reactions. This is based in part on changes in the community since the arrival of the mine, such as rising housing prices and inflation. It is also based on the perception that mining operations have contaminated and siphoned off local water supplies, and are negatively affecting human health, farming yields, and fishing. The matter is further complicated by involvement of activist groups, who are using the Internet to spread information, in some cases destabilizing relations between the company and the community. Local distrust is at such a high level that when Newmont Mining began exploration of a nearby mountain as a potential site for further mining activities, rioting began and the company abandoned its expansion.
- ***An employee base that is deemed unacceptable to society***: Wal-Mart recently settled a lawsuit brought by the U.S. Department of Labor for $135,540, for 24 violations of employing teenagers and allowing workers to operate hazardous equipment.[12] Although the amount of the settlement may be insignificant to the company, the negative impact on its reputation is reverberating through the company.

The new power of communications technology to spread information quickly and efficiently, with little oversight, means that companies have to be even more aware of their social and political risks to avoid targeting by activists. This is discussed further in Appendix 1: Real vs. Perceived Risk.

Exhibit 6 outlines some of the social and political risks generated by *product, sector, customer, geographic location, employee base, and industry characteristics*, as well as examples of industries affected by these issues. Risk can be divided into: (a) risks to society that could create dissatisfaction, and (b) other issues that could negatively affect the company, thereby posing risk to the company. Analyzing the characteristics of these two kinds of risk, aids companies in understanding their potential impacts on the company or project, a critical first step in developing a risk profile and estimating the effect on profitability.

A comprehensive risk identification process will ascertain risk variables that may apply to one's company. Additionally, identifying the issues to which stakeholders may be sensitive (if they were to discover companies engaged in them) is important, since the financial effects of stakeholder reactions can be significant and easily spiral out of control.

Element 2: Identify Company- or Project-Relevant Social and Political Risks

Next in critical importance after identifying general enterprise risk sources and issues (Element 1) is identifying company- or project-relevant social and political risks. These can vary, depending on specifics such as location within a country, and can be more nuanced than those previously identified. The discussion of risk management often focuses on financial issues, to the exclusion of other similarly important matters.

Although the CEO and the board are the ultimate risk managers in the company, employees in many parts of a company can

11. "Where You Live Affects What You Eat." NAASO, *The Obesity Society*. http://www.naaso.org/news/20041118.asp

12. "Wal-Mart settles child labor cases. Company denies charges but agrees to pay penalty." Associated Press, February 12, 2005.

EXHIBIT 6: EXAMPLES OF RISK SOURCES & CORRELATED POTENTIAL RISKS

Source	Examples	Risk	
		Risk to Society	**Risk to Companies**
Product	Diamonds	• Diamond trade and revenues being siphoned off by corrupt governments and rebel groups, thereby fueling civil wars in Africa, e.g. Angola	• Business disruption, threats to employees • Reputation: profits from legal diamond mining fueling civil wars in Africa. • Accusations of profiting from trade of "conflict diamonds" may affect sales and product reputation • Consumer boycotts/protests and pressure from employees (both existing and potential)
	Petroleum products	• Negative environmental impact	• Long-term business sustainability (need to replace reserves, etc.) • Imposition of legislation to manage emissions, creating a cost to the company and consumers of its products • Reputation: fossil fuel emissions correlated to climate change
	Fast food, snack foods, soft drink manufacturers, food retailers	• Increased consumption of unhealthy food and drinks negatively affecting obesity in the developed world and potentially the less developed world	• Reputation: blaming food and drink manufacturers, as well as retailers, for producing and marketing food to consumers who over-consume, thereby suffering from obesity and related health problems • Obesity lawsuits that, to date have been thrown out of court, but may still pose significant potential liability, as was exemplified by tobacco lawsuits. These suits, whether or not they lead to payouts, take time and energy from corporate legal teams and executives to address, at considerable cost to the firm.
	Prescription drugs	• Lack of access to medicines in developing countries, e.g. South Africa and HIV cocktails	• Reputation: Anger in developed world about lack of access to essential medicines for the world's poorest leads to action and/or public protest in developed countries where companies are based • Cost to pharmaceutical companies of filing lawsuit to overturn South African law lowering price of HIV medicines • Cost of withdrawing the suit and public outcry at blocking access to medicine in Africa. Consumer boycotts/protests and pressure from employees (both existing and potential). • No legal liability but cost of negative public opinion once the issue becomes public. Consumer boycotts/ protests and pressure from employees (both existing and potential).

(*continued*)

EXHIBIT 6: EXAMPLES OF RISK SOURCES & CORRELATED POTENTIAL RISKS (*continued*)

Source	Examples	Risk	
		Risk to Society	Risk to Companies
	Shoes, clothing, toys	• Potentially poor working conditions, including long hours and little pay	• Reputation: Accusations by consumers of sweatshop conditions leading to boycotts of products • No legal liability but cost of negative public opinion once the issue becomes public. Consumer boycotts/protests and pressure from employees (both existing and potential).
	Chocolate	• Slave labor, child labor and people trafficking in West Africa	• Reputation: boycotts of products and bad publicity connected to use of slave and child labor, as well as human trafficking • Lawsuits under the Torture Victims Protection Act and the Alien Tort Claims Act (U.S. court). • Consumer boycotts/protests and pressure from employees (both existing and potential)
	Chemical	• Negative environmental impact • Employee health • Community safety • Risk perception • Long-term hazards that may not be currently understood but may take years to emerge	• Fines by government • Lawsuits • Remediation • Consumer boycotts • Inability to recruit talent • Reputation risk
Sector	Retail		• Companies that sell products such as diamonds, fast foods, snack foods, soft drinks, chocolates, shoes, clothing, toys, furs, etc. could be faced with the same risks as the producers and may be met with lawsuits and/or boycotts
Customer	Socially responsible consumers (particular correlation with products produced in developing markets)		• Reputation issues • Consumer boycotts • Inability to recruit talent
Geographic location[13]	Stable developed country	• Locating certain businesses near particular areas (taverns, liquor stores near schools).	• Limits ability to open in certain locations • Consumer reputation risk

13. The distinction between developed and developing countries is often based on levels of economic development, which are usually closely associated with social development, in terms of education, health care, and life expectancy. The United Nations' Human Development Index (HDI) serves as a measure of development, as does the World Bank's *Country Classification Database*, which uses gross national income (GNI) to classify economies and their level of development.

EXHIBIT 6: EXAMPLES OF RISK SOURCES & CORRELATED POTENTIAL RISKS (*continued*)

Source	Examples	Risk	
		Risk to Society	**Risk to Companies**
	Unstable developing country	• Government is supportive of company but local population could be dissatisfied	• Potential for corruption creating difficult situations when trying to uphold home country law [such as Foreign Corrupt Practices Act (U.S.)] • Legal framework where contracts cannot be enforced creating an uneven playing field • Targeting by predatory government with potential for nationalization of assets [Bolivia LNG, Venezuela general corporate challenge] • Targeting by insurgents or other non-government actors [i.e., insurgents if company seen as colluding with government (Colombia)]
Employees	Children	• Working at young ages [This may not be as much of an issue for local population when the alternative to child labor can be a worse option, such as child prostitution or homelessness]	• Reputation issues: Anger in consumer markets about use of child labor • Violation of child labor laws
	Adults	• Female employees' exposure to hazardous materials that cause birth defects • Social issues with women working • Discrimination • (Men) Working, particularly in extractive and transport industries, away from their families and communities, risk exposure to sexually transmitted diseases (STDs) and increased drug and alcohol use. The STD is often transmitted to others, including women along the trucking route or wives.	• Loss of skilled employees • Health problems among employees • Potential that consumers will react negatively to poor working conditions • Lawsuits • Increased absenteeism due to illness, higher turnover of workers due to HIV-related deaths • Increased instance of industrial accidents because of intoxication by drugs or alcohol
	Non-diverse workforce in North America, Europe		• Lawsuits filed under laws such as the Racial Discrimination Act, the Sex Discrimination Act • Reputation loss that affects ability to hire talented workers • Legal fees • Inability to recruit • Potential obstruction in capturing growing minority markets

integrate risk management into their jobs. Financial risk is usually managed in a specific and established manner. On the other hand, the intensification of social and political risks often requires an integrated risk management process across a firm, to adequately identify emerging issues. Personnel who can become aware of risk at an early stage include a line manager at a plant in a developing country. That manager may be aware of negative community reactions to the corporation through discussions among workers, or from personnel in public affairs who learn of negative government attitudes to the firm while lobbying. These first signals can herald much larger issues if left ignored.

To anticipate social and political risks, personnel must be aware of what constitutes risk to the firm, and understand how to identify these risks. Identification is a two-step scanning process:

1) Generate a **risk profile** for the corporation (Element 1) that can include some of the issues illustrated in Exhibit 4. A variety of risks can materialize from factors such as sector, industry characteristics, product, customers, geographic location, and employment. A risk profile is simply a list of risks generated from these contextual issues.
2) Generate a **risk catalogue** for the corporation (Element 2): risks can be specific to a particular project or location. For example, a new shoe manufacturing plant in Bolivia will face different risks than an existing refining facility in Oman. A risk catalogue is simply a more specific list of 'red flag' issues, developed from the general risk profile, that are connected to a certain project or location.

Existing Operations vs. New Investments

Evaluating and responding to risks is significantly different for existing operations than for new investments. Ongoing operations are often difficult or costly to uproot if a major risk materializes. In some cases, such as extractive or other materials-based operations that bring a company to a particular location and require large initial investment, the risk would have to be imminent, or have the potential to exact enormous consequences, to warrant moving operations or withdrawing. When ongoing operations face social and political risks, they must find ways of minimizing their impact, while maximizing their potential for continuing operations. The same applies to changes to operations that generate risk. However, when new investments are considered, companies can evaluate a variety of locations and compare their risk impacts. In addition, evaluating risk for new operations can present opportunities for pre-emptive mitigation and management of unavoidable risks. That is not possible in ongoing operations. Risk mitigation is discussed in a later section.

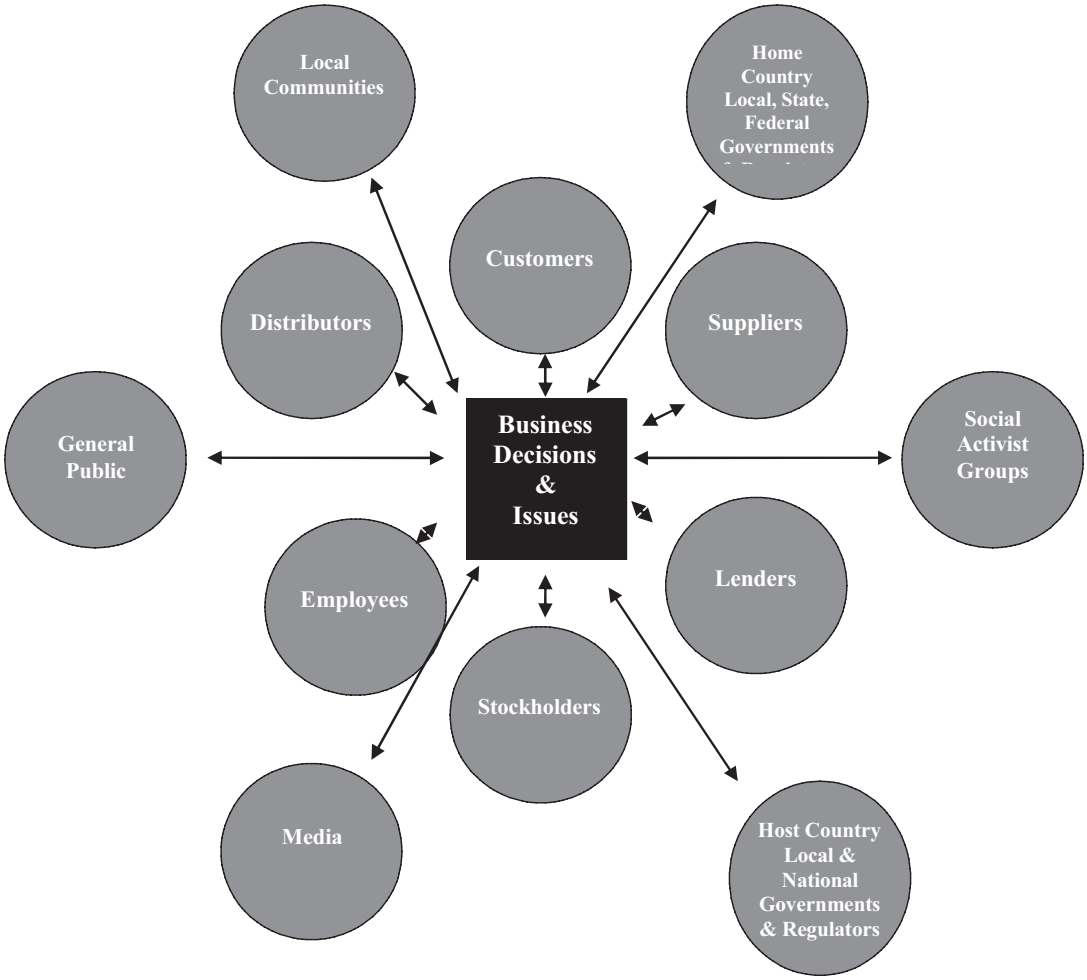
Reputation Risk

For most firms, reputation is a large issue, and intangible assets such as brand can account for over 60% of a company's market value. Reputation damage from issues such as negative publicity and costly litigation can create a loss of revenue, a decline in customers, or the exit of key employees. (Argenti; 2005) Negative perceptions about a corporation can emerge from the social and political issues it deals with, and put the company's reputation at risk. Although a good reputation can have potentially positive outcomes, such as (a) enhanced access to capital markets, and (b) the ability to attract investors and better employees, and charge premium prices, the converse can also be true. Reputation issues arising from social and political risk can negatively affect the organization as much as the risks themselves, and can account for some of the largest costs—lost sales and profits. As a component of social and political risks a company faces, reputation risk also needs to be managed.

Increased consumer interest, instantaneous communication via the Internet, and professional activist organizations have generated new challenges for companies trying to manage reputation risk. They must identify the stakeholders that may be affected by, or may have an impact on, a particular issue. Exhibit 7 illustrates stakeholders that may be involved.

Evaluating a firm's stakeholders and the reputation risks they may generate is an important part of creating the corporate risk profile. Identifying these reputation risks follows the same steps used in identifying political and social risk. Identifying the stakeholder group that is the source of this reputation risk is also critical to creating mitigation strategies. Risk identification does not have to be a long and costly process—even a few people spending a few hours discussing and identifying risks, and assigning probability values to them, can produce helpful, if not precise, results. This is better than no risk deliberation at all. More thorough deliberations can be expected when more money is at stake.

Exhibit 7: Potential Stakeholders



Embedding Risk Identification into Corporate Activities

Identifying a company or project's social and political risks, and their associated reputation risks, should generate a company- or project-specific risk catalogue that includes all relevant risks and their sources. Internal company expertise and external advisors together can perform the identification.

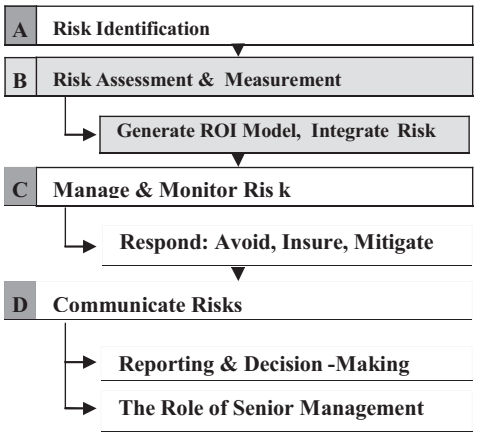
- ***Internal analysis:*** Either (a) employees specifically hired for the purpose, or (b) personnel located in key locations who interface with local and national social and political entities such as local leaders, politicians, NGOs and communities, can gather this risk information. They would know the business and therefore understand how particular social and political issues may affect the company. They will need a means of reporting on risks they identify. Coming from within the company, these personnel may, however, have a narrower view of the industry as a whole and be less sensitive to 'red flags' generated outside the company. Therefore, other sources of risk data can be used for a more inclusive set of risk indicators.
- ***External analysis:*** Boutique political risk analysis firms (such as those listed in Appendix 2) are another source of risk data. These organizations supply country-specific reports. In some cases, they also calculate national ratings based on issues such as: risk from government, society, security, and economic factors. The benefit of information from this source is that (a) they give a broad understanding of a country's current situation, (b) they update the information regularly, and (c) those generating the data are deeply

knowledgeable about the regions they cover. In addition, the country risk ratings simplify the process of comparing countries. This is particularly useful when beginning new operations and trying to decide where to locate them. One limitation of the products these firms generate is that they are usually neither industry- nor region- specific. This is significant, since what could be lethal to one industry located in one part of a certain country could pose no threat whatsoever to another. In addition, these firms' products are not monetized so as to be useful in investment decision-making.

- ***Stakeholder scanning:*** Stakeholders such as suppliers, consumers, and surrounding communities are sources of data on social and political risk. Information can be gathered from surveys, interviews, community meetings, and market perception studies, as well as hiring local advisors. The drawback of these methods, particularly in countries where new operations are being established, is that undertaking the study could reinforce existing expectations of stakeholders that the company will find hard to meet. In addition, engaging stakeholders can sometimes embroil the company in local politics in unanticipated ways. For these reasons, a company wanting this information would be wise to seek assistance from a third party, or hire personnel trained in conducting social impact assessments.

It is possible, and likely most useful, to combine elements of all of the above methods. For instance, a company could assign general risk oversight to several people within the company, while also enlisting personnel in the field and training them to be aware of 'red flags' indicating potential problems. Boutique political risk firms could supplement this country information at various stages of operations, and a social impact assessment could be undertaken periodically within the project life-cycle by a lending agency, a third party, or specifically hired personnel. This process should not, however, become all-consuming. Instead, companies should adopt a methodology for gathering and reporting information that is appropriate to the company and the project. Section IV further discusses reporting and decision-making.

II. ASSESSING & MEASURING SOCIAL AND POLITICAL RISK

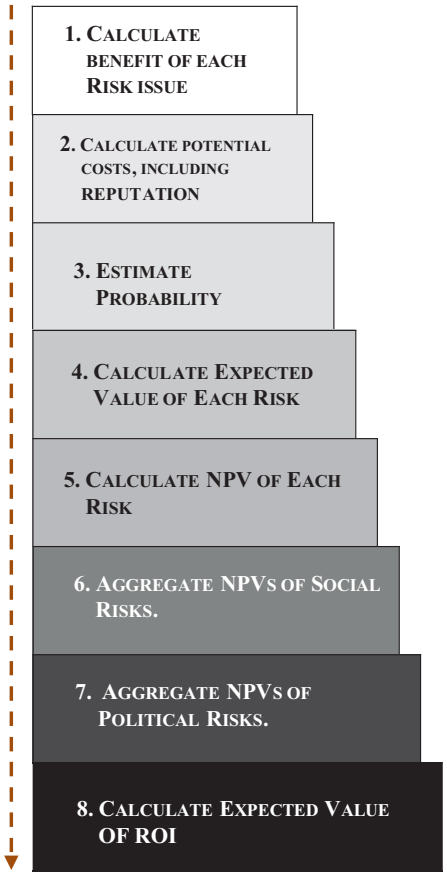


Business resource allocations are primarily based on ROI calculations. For a more complete analysis and improved operational and capital investment planning, ROI calculations must include political and social risks, to make them more explicit and relevant.

After identifying the social and political issues that could affect the company, and compiling those issues into a comprehensive risk profile, metrics must be developed for each issue to assess their relative potential impact. One of the main aims of quantifying social and political risks is to integrate them into a financial model, thereby incorporating social and political issues into traditional risk analysis. We recommend including social and political risk in the financial equation through an ROI model, described below. Measurement of social and political risk through the following eight-stage process is illustrated in Exhibit 8:

1. *Calculate the **benefit** associated with each issue that may generate risk:* For instance, shifting operations to Bangladesh could save significant money to a company's payroll by employing personnel earning less than home office personnel.
2. *Calculate the potential **costs** associated with each political or social risk, including reputation costs.*
3. *Estimate the **probability** that each risk will materialize.*
4. *Multiply the potential cost of each risk by its expected probability of materializing to calculate the **expected value** of each risk.*

Exhibit 8: Stages to Measuring Social and Political Risk



5. *Estimate when, over time, the risk may emerge. Calculate the net present value (**NPV**) of the risk.*
6. ***Aggregate the NPVs of all social risks.** Insert as a line item in ROI calculations.*
7. ***Aggregate the NPVs of all political risks**. Insert as a line item in ROI calculations.*
8. *Calculate the expected value of the **ROI**.*

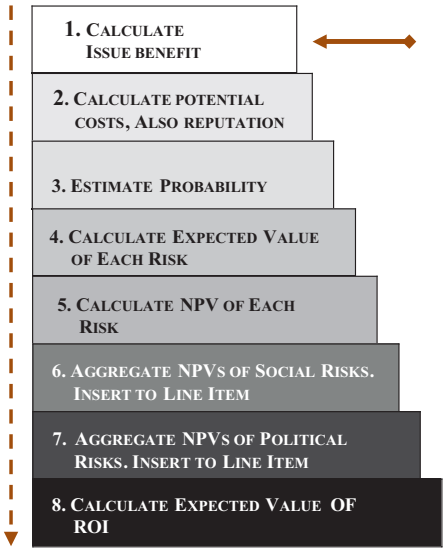
Social and political issues pose risks to companies that can be quantified and monetized, even if only by a rudimentary estimate. In fact, risks should be monetized for inclusion in ROI calculations, and to improve resource allocation and investment decisions. Product take-back and producer responsibility (requirements that companies accept responsibility for final disposal of their products like computer goods, cartridges, appliances, etc.) is increasingly common throughout the world. Similarly, site cleanup has become mandated in many locations, and companies are now recognizing that they did not consider these social and political risks when making costing decisions. This has led to underestimating total product cost. Better forecasting of potential changes in the social and political environment can lead to improved decision-making on process, product, and capital investment.

Like other estimates used in financial analysis, these estimates are often imprecise. However, through proper estimating and disclosure, they certainly aid decision-making and are relevant in management discussions. Often, decision-makers will estimate ranges of costs and choose a point estimate for use in the analysis. The ranges, along with the measurement techniques used in the ROI analysis, would then be included as a footnote or appendix to the ROI calculation. Discussion of these ranges, and decisions on a certain point estimate, assists personnel in thinking about and communicating these often-neglected risks. Although the output of this practice is important, just as critical, ultimately, is the process for deciding on the appropriate issues, their associated costs, and the probabilities of occurrence. Ultimately, it is the board, the CEO, or the CFO, who must choose the appropriate metric. The quantitative analysis, ranges, point estimates, and ensuing discussion are critical elements in decision-making. The assumptions, decisions, and measurement techniques that lead to quantification of social and political risks must therefore be included as a footnote or appendix to the ROI analysis.

Although calculations of the expected values of individual risks may be imprecise, the total estimate will likely move towards the mean. This greater precision occurs in a manner similar to the portfolio effect, where the propensity of risk on a well-diversified set of investments tends to fall below the risk of each individual component.

Measuring the Cost of Risks

Step 1—Calculate Issue Benefit



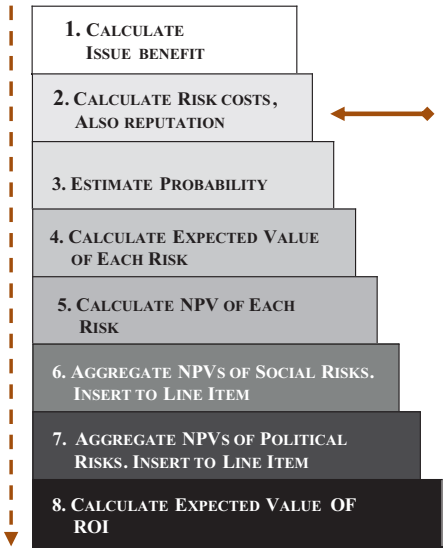
Measuring the cost of social and political risks involves monetizing the savings and costs associated with each issue that could generate risk.

For example, when corporations are considering operating in a region where child labor is the norm, they may contemplate following this norm. In considering this option, the savings from using children would be calculated by measuring the difference in the wage rates between paying an adult and a child. The savings of using child labor would represent the **issue benefit**, which is generally assigned a positive value.

Although some industries like clothing and shoe manufacturing have been seriously damaged by the use of child labor, and have therefore attempted to stop the practice, others like the chocolate industry did not consider this a risk. Children working as cocoa bean pickers were employed in the supply chain. Chocolate and candy manufacturers largely ignored the issue, until newspapers began publishing stories of kidnappings and forced child labor on cocoa plantations in West Africa. If the company considered this outcome, it should calculate each potential cost associated with employing this labor force, and the public discovering it. These costs could include:

- Lost sales and other reputation impacts (measuring reputation is addressed in a later section);
- Managing a consumer boycott by hiring a public relations firm, creating a new advertising campaign, hiring a stakeholder relations manager, communicating internally with employees, and senior management's time devoted to dealing with the issues;
- Diminished brand value; and
- Negative impact on recruiting potential hires.

Step 2—Calculate Risk Costs, Also Reputation



Each of these costs is assigned a value to get the **risk costs** of employing child labor.

Measuring Reputation Risk

Reputation risk is considered a cost resulting from, and therefore a secondary effect of, social and political risk. These include all of the real and perceived risks discussed in Appendix 1. The process of identifying and measuring reputation risk is the same as for political and social risk.

Polling firms, a public relations team, and information from other companies, can identify which stakeholders may view certain social and political issues negatively, thereby generating reputation risk. Exhibit 8 lists a number of stakeholders that should be considered.

- **Third-party polling:** Polling by opinion research firms can provide a sense of how important these issues are to the company's stakeholders, and how they might react. A company's public relations team can calculate the impact of reactions like opting for another brand, boycotting, or a negative media campaign, based on numbers provided by polls and using methods similar to measuring brand value.
- **Surveys:** Surveys can give some insight into the intensity of stakeholder reaction to certain issues. These "intensity of feeling" polls can be translated into monetary terms by asking questions about the impact of certain issues on buying products. The resulting numbers can then be calculated as lost sales.
- **Other companies:** Researching the impacts on other companies that have experienced a similar issue can give insight into the monetary impact they experienced.

The biggest cost of social and political risk is usually a reputation cost, typically as a result of lost sales due to consumer boycotts or protests. This can be measured through lost sales minus the cost of producing those goods, or the *lost net profit*.

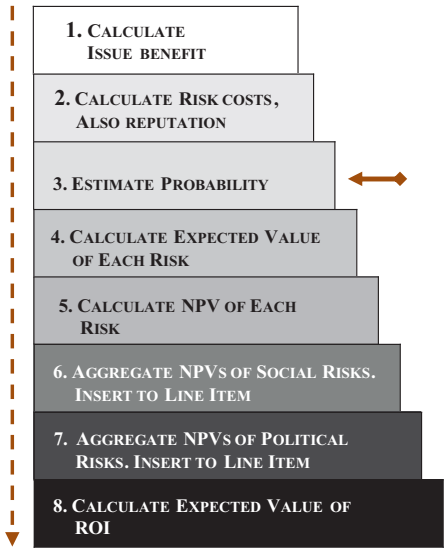
Share price and *market share decline* are two other potential issues to consider. Perrier was once the leading sparkling water brand in the U.S., holding 80% of the U.S. imported bottled water market and close to 6% of the total bottled water market. In 1990, benzene was found in the bottled water sold in South Carolina and the company recalled 70 million bottles in the U.S. and Canada, while claiming that it was an isolated incident. When similar contamination was discovered by Danish and Dutch officials, the company did a worldwide recall and claimed that benzene naturally occurred

in the carbon dioxide that makes its water "sparkling", and was usually filtered out. They lost substantial market share. Six years later, Perrier's sales was still at only one-half of its 1989 peak, and Perrier had to spend large amounts of money on increased advertising, free samples, and make other marketing and promotional expenditures in an attempt to recover its market share.[14]

Where possible, the impacts of share price and market share decline should be included in calculations as potential long-term losses. The costs of managing stakeholders in the medium to long-term, either through additional personnel or other strategies, should also be included.

The professional services and insurance firm, Marsh & McLennan Companies, Inc., experienced a 40 percent drop in its stock price when accusations of bid-rigging activity made the news in November, 2004. In addition to a downgrade of its debt by credit rating agencies due to its deteriorating reputation, Marsh & McLennan cut 5% of its workforce on predictions of a 94% decline in its 3rd quarter profits.[15]

Step 3—Estimate Probability

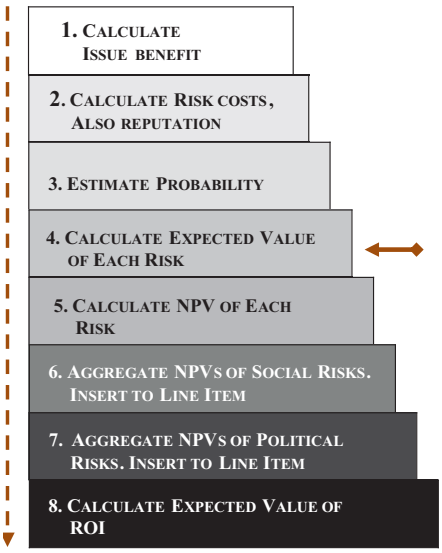


After calculating the potential costs of each risk to the company, the potential likelihood, in percent, that each risk would occur and cause damage to the company, is approximated. This number is the **estimated probability**. (Later we calculate the impact on the company in expected value.)

However, a footnote can be included in the ROI analysis that indicates that these numbers are midpoints (which would most likely settle within a range). An estimated probability should be assigned to each identified risk. For example, the estimated probability of the emergence of social and political risks for a fictitious coffee processing plant in Colombia could include:

- Workers being kidnapped by the local militia: 60%;
- Being "taxed" by local militias or cartels: 25%;
- Being found guilty and paying fines under the U.S. Foreign Corrupt Practices Act or other home country laws that regulate bribery and payoffs: 6%;
- Supplier's coffee plantation destroyed by crop dusters as part of local government-led cocaine eradication scheme creating a supply gap: 27%.

Step 4—Calculate Expected Value of Each Risk



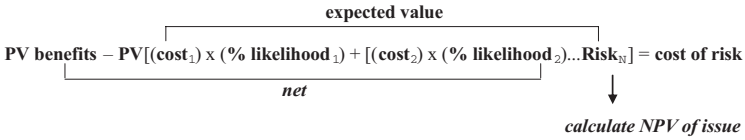
After approximating the estimated probability, the **expected value** for each risk is calculated, by multiplying the **estimated cost** of the risk by the percent **estimated probability** of its occurrence. For example, if the costs of a reaction to use of child labor are estimated to be $100,000, and the likelihood that this risk would materialize is estimated 10%, then:

Child Labor Risk Expected Value = ($100,000) x (10%) = $10,000

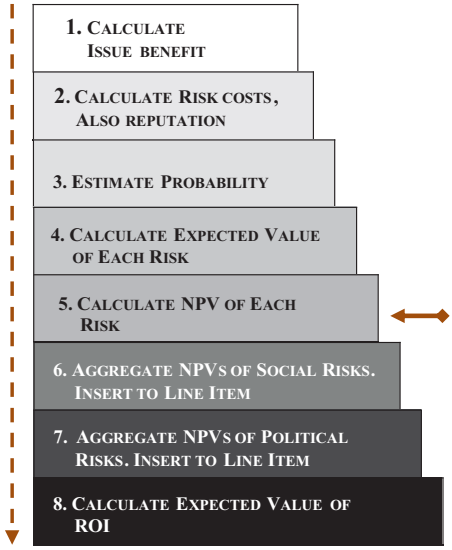
14. "Perrier, Nestlé, And The Agnellis," Thunderbird Business School Case Study

15. "Marsh & McLennan to cut 3,000 jobs," *The Business Journal of Milwaukee*, November 9, 2004, and "Cherkasky says Marsh may settle Spitzer's lawsuit within a month: CEO is seeking to fix 40% drop in share price," *The Boston Globe*, November 23, 2004.

After steps 1-4 have been completed, the net present value (NPV) of each issue is calculated. Note that each issue has risks that emerge at different times. NPV is calculated on the outcome of:



Step 5—Calculate NPV of Each Risk



NPV calculations for social and political risk are completed in the same way as traditional NPV calculations. Therefore, companies can use a table like that in Exhibit 9 to input the cost that the risk will incur, and the year that it will occur. Discounting back, using a set discount rate, is done in the traditional manner. These calculations are carried out for each identified social and political risk. For the purposes of these exhibits, we assume that project revenues and costs are converted to cash in each current year. The following example of a coffee plantation in Colombia illustrates this methodology.

Calculating NPV for Social & Political Risk: An Example[16]

In this example, a corporation already in the coffee-growing business is developing a coffee plantation in Colombia. Risks related to the coffee market, the corporation as a whole, and so on, need not be considered since the company is already in that business. The risks that do need to be considered are those pertaining to this particular project. Earlier in this Management Accounting Guideline (MAG), we identified a number of typical social and political risks/business decisions that any project would face; in Exhibit 9, we include those that could apply to this project.

For the purposes of the example, we have selected the business decision on possible use of child labor to reduce project costs and thus increase profitability and/or reduce the product cost to consumers. Since this is an opportunity (rather than a risk), the first step is to quantify the gross benefit, say $8 million/year, an amount partially offset by $300,000 in up-front training and related costs (year 1 only).

The second step is to quantify the risks by determining the probability of each risk occurring, and its financial impact. This is shown in Part 1 of the table in Exhibit 9. The direct net benefit of the opportunity is therefore expected to be:

- Year 1: $8,000,000 – 300,000 – 1,530,000 = $6,170,000
- Year 2: $8,000,000 – 2,880,000 = $5,120,000
- Year 3: $8,000,000 – 5,580,000 = $2,420,000
- Year 4: $8,000,000 – $1,380,000 = $6,620,000

Assuming a 10% discount rate, the Net Present Value of this opportunity (assuming that the benefits and costs are incurred in the middle of each year) is calculated as (all figures rounded to nearest '000):

- $6,170,000 discounted 6 months = $5,876,000
- $5,120,000 discounted 18 months = $4,433,000
- $2,420,000 discounted 30 months = $1,905,000
- $6,620,000 discounted 42 months = $4,737,000
- NPV = $16,951,000

However, this analysis does not yet reflect the impact on the company's reputation and resulting lost sales, nor the efforts required to recoup those losses. Here are some common examples of elements of reputation risk:

1. Employee relations and attitudes
2. Product quality, reliability, safety
3. Customer relations
4. Presence in foreign markets (i.e. not is it in market x but how does it act, how is it perceived?)

16. We thank Robert Torok for this example.

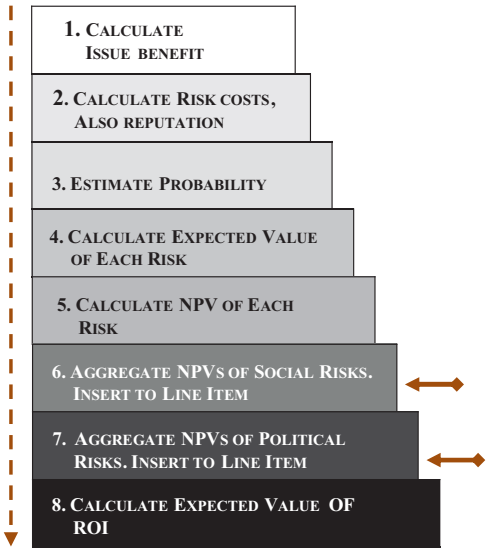
5. Supply chain partners and practices
6. Community relations
7. Fiduciary responsibility
8. Behavioral standards, code of ethics, etc. (loosely called business practices)
9. Quality of management

For purposes of the example, the company considers elements 1, 3, 6, and 8 to be relevant. The approach then follows the same steps as were taken earlier for the quantitative aspects, that is, estimate the probability of the impact being felt, its timing, and the resulting costs. The principal differences when dealing with reputation risk are that second-order effects, including the costs of mitigating the initial loss and a longer period, are involved.

This is shown in Part 2 of the table in Exhibit 9, which calculates reputation risks totaling $2,675,000 in year 1, $5,350,000 in year 2, and so on through year 6. The NPV of these risks can also be calculated. Again assuming a 10% discount rate and that all costs are incurred mid-year; the NPV of the risks would be approximately $38.5 million.

In total, therefore, the NPV of the opportunity = $16,951,000 - $38,500,000 = ($21,549,000) - a rather poor choice!

Steps 6 and 7—Aggregate NPVs of Social Risk; Aggregate NPVs of Political Risk



Once all NPVs for social and political risks have been calculated, the social risk NPVs should be added together, as should the political risk NPVs. The aggregate social risk NPV and the aggregate political risk NPV should then be inserted as line items in the normal ROI calculation. Schedules should be provided that show the calculations of benefit, expected value, likelihood, and cost of social and political risk, as illustrated in Exhibit 10. It is critical that senior management see both the process and the output of doing these calculations.

Schedules A and schedule B in this exhibit list examples of mock social and political risks. Schedule A lists risks that could emerge for a company, for instance in the extractive industry, that operates in an unstable region. Although some issues that emerge, such as civil unrest near the site, would likely not present any benefits, others, such as establishing operations on indigenous lands, can produce short-term savings because of low land prices. However, costs associated with these social risks are incurred that include:

- Remuneration for indigenous land;
- Hiring someone to negotiate with protesters or assigning some of current employees' time to those negotiations;
- The cost of extra security to protect the site;
- Hiring a community relations manager;
- Executive time spend strategizing on managing NGO relations;
- Work stoppages due to community protests;
- Reputation damage; and
- The potential for litigation fees and fines if the issue goes to court.

Unlike some social risks, most underlying causes of political risks do not present any savings to a company. Although entering a country with political instability can bring both benefits and costs, anti-business legislative changes, policy changes or contract re-negotiation that would be considered risks offer a company little or no benefit. Favorable policy or legislation changes, however, would not be considered political risk as defined here. Schedule B lists various costs the company would incur if the risks mentioned were to materialize. For instance, if there is an armed insurrection targeting the company site, costs could include:

- Hiring private security to protect executives and their homes;
- Training personnel in self-defense (defensive driving, home invasion protection, etc.); and
- Extra training of local police who protect the company site on the level of force company standards allow (where they go beyond local laws), to protect the company from litigation for human rights abuses.

Exhibit 9: Example of NPV Calculation for Child Labor Risk

Part 1—Direct Financial / Business Risks

Risk #	Potential Risk	Probability of Risk Being Realized in: Year 1	Year 2	Year 3	$ Impact	$ Impact in the Year if Risk is Realized: Year 1	Year 2	Year 3	Year 4 (Note 4)
1	Children are less productive than adults	20%	20%	20%	$900,000	$180,000	$180,000	$180,000	$180,000
	Use of child labor becomes public knowledge	25%	50%	100%					
2.1	Value of management time to deal with the issue				$1,000,000	$250,000	$500,000	$1,000,000	$500,000
2.2	Cost of combating domestic legal challenges				$1,000,000	$250,000	$500,000	$1,000,000	$400,000
2.3	Cost of conviction under relevant statutes (probability of conviction = 30%)				$10,000,000	$750,000	$1,500,000	$3,000,000	$0
2.4	Additional site security				$400,000	$100,000	$200,000	$400,000	$300,000
	Total Direct Risk Costs:					**$1,530,000**	**$2,880,000**	**$5,580,000**	**$1,380,000**

Part 2—Reputation Risks

Risk #	Potential Risk	Probability of Risk Being Realized in: Year 1	Year 2	Year 3	$ Impact	$ Impact in the Year if Risk is Realized: Year 1	Year 2	Year 3	Year 4	Year 5	Year 6
	Use of child labor becomes public knowledge	25%	50%	100%							
3.1	Cost of reduction in employee morale & productivity;										

	greater turnover, recruiting challenges	$3,000,000	$750,000	$1,500,000	$3,000,000	$1,000,000	$500,000	$0
3.2	Loss of margin due to weaker customer loyalty leading to reduced sales	$6,000,000	$1,500,000	$3,000,000	$6,000,000	$5,000,000	$3,000,000	$1,000,000
3.3	Loss of margin due to poorer community image leading to reduced sales	$4,000,000	$300,000	$600,000	$1,200,000	$800,000	$4,000,000	$0
3.4	Increased cost due to pressure to strengthen codes of conduct/behavior	$500,000	$125,000	$250,000	$500,000	$100,000	$0	$0
	Total 1st Order Reputation Risk Costs:		**$2,675,000**	**$5,350,000**	**$10,700,000**	**$6,900,000**	**$7,500,000**	**$1,000,000**
4.1	Cost of increased advertising to drive sales to previous levels (see Note 3)				$3,500,000	$2,500,000	$1,000,000	$500,000
4.2	Lost margin due to lower prices to drive sales to previous levels (see Note 3)				$4,200,000	$3,100,000	$1,800,000	$500,000
	Additional 2nd Order Reputation Risk Costs:				**$7,700,000**	**$5,600,000**	**$2,800,000**	**$1,000,000**
	Total Reputation Risk Costs:		**$2,675,000**	**$5,350,000**	**$18,400,000**	**$12,500,000**	**$10,300,000**	**$2,000,000**
	NPV	**$38,489,109**	**$2,547,619**	**$4,632,035**	**$14,482,487**	**$8,944,224**	**$6,700,037**	**$1,182,707**

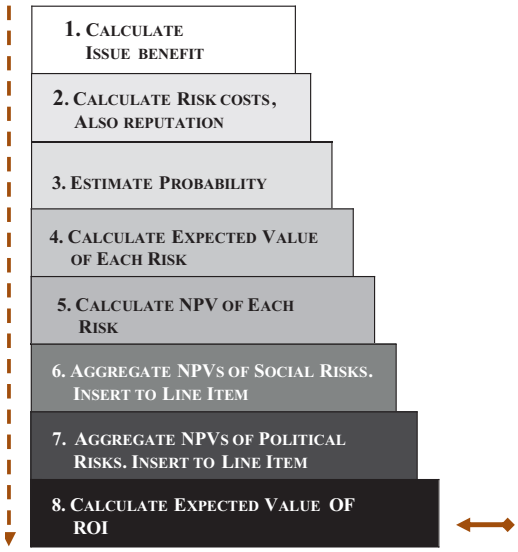
NOTES:
1) If the knowledge becomes public in year 1, one-time costs are realized then, but not thereafter. For simplicity, this situation is not shown.
2) In this situation, the probability increases from year 1 to year 2. But if the knowledge becomes public in year 1, then the year 2 probability becomes 100%; however, to simplify the example, this situation is not shown.
3) To keep the example even more simple, it will be assumed that these costs are incurred starting in year 3 and continue at lower rates through year 6, after which they stop. The lost sales or margins begin to recover but take through year 6 to fully return to previous levels.
4) Some costs will 'wither away' in years 4 and on as the issue fades from the public eye; one can assume zero after year 4.

If the company overseas faces endemic corruption, costs associated with this risk could include:

- Dollars (or equivalent) paid directly in bribes, or other methods of payment to facilitate transactions;
- Legal fees and fines if found guilty of bribery practices in a lawsuit filed under the Foreign Corrupt Practices Act or similar legislation; and
- Reputation damage sustained by the company for being associated with a corrupt regime.

Reputation costs have been included as a separate line item in each schedule because they represent a large component of social and political risk. In addition to how reputation costs were treated in the previous reputation risk section, they can be listed as lost sales and profits.

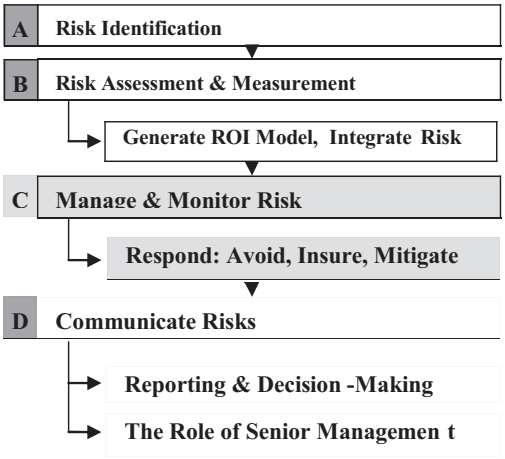
Step 8—Calculate Expected Value of ROI



Once Schedules A and B have been calculated, their results can be integrated into traditional ROI calculations, as illustrated in Exhibit 10.

Integrating political and social risks into ROI calculations enables managers to better understand (a) the full range of risks their operations face, and (b) their costs. Although the output of the analysis is useful, the analyzing process itself also provides the opportunity to strategize for risk management—either to develop ways to avoid the risk, or to create risk mitigation plans.

III. MANAGE & MONITOR POLITICAL AND SOCIAL RISK



• Responding to Risk: Insurance, Avoidance, Mitigation

Taking these steps to identify social and political risks and to measure their potential costs begins a process of integrated risk management that (a) allows for a new understanding of the full scope of operating risks, and (b) provides the groundwork for managing these risks. Unlike financial risk, which can usually be shared or transferred, this is often not possible with social and political risks in an environment where firms are often held liable for their suppliers' misdemeanors, either in the court of law or public opinion. In the early 1990s, when Nike's global labor practices were being criticized, protesters did not typically differentiate between the company's 20,000 employees and the half million indirect contractors working in 565 contract factories in 46 countries, about whose working conditions they were protesting. Photos of children in Pakistan sewing soccer balls in dismal conditions peppered the news, as did stories of paying women 14 cents per hour to sew shoes in Indonesia, and workers' exposure to toxic chemicals in Vietnam. Nike did not have the option to buy risk insurance to mitigate the losses incurred from these anti-Nike campaigns. Nor could the company distance itself from the subcontractors who ran the contract factories and set the rules—this had been Nike's initial response, but it failed to stem the tide of criticism.

Managing political, social, and reputation risk includes devising policies and programs to

EXHIBIT 10: Integrating Social and Political Risk Costs in ROI Calculations

1 **CALCULATE THE MONETARY BENEFITS OF THE PROJECT**

OUTPUT	REVENUES	NPV
New product	Added revenue stream	$.....
	Labor cost savings	$.....
	New customer base	$.....
	Total Benefits	$.....

2 **CALCULATE THE TOTAL COSTS OF THE PROJECT**

COSTS		NPV
Shipping	Transport rates, import duty, transporting goods from port to factory	$.....
Raw materials		$.....
Labor		$.....
Total Social Risk costs	See schedule A	$.....
Total Political Risk costs	See schedule B	$.....
	Total Costs	$.....

3 **CALCULATE THE PROJECT ROI**

$$\text{ROI} = \frac{\text{Total Benefits} - \text{Total Costs}}{\text{Capital Costs (Investment)}} * 100$$

SCHEDULE A | **COSTS OF SOCIAL RISKS**

Risk	Benefit	Cost types	Costs	Likelihood	Expected Value
Civil unrest surrounding site	$.....	▪ Costs of engaging employees skilled in negotiating with protesters ▪ Cost of engaging extra security personnel *Reputation-Related:* ▪ Cost of hiring community relations manager ▪ Cost of managing activist NGO relations	$..... $..... $..... $..... $..... $.....	..... %	$.....
Prostitution near site	$.....	▪ Costs of implementing health education for workers to teach about sexually transmitted diseases (to avoid costs related to HIV infection)	$..... $..... $..... $.....	..... %	$.....
Child Labor	$.....	*Reputation Related:* ▪ Costs of reputation damage ▪ Cost of managing boycotts when information reaches activist consumers ▪ Cost of NGO-relations manager	$..... $..... $..... $..... $.....	..... %	$.....
Infringement of indigenous lands	$.....	▪ Costs if litigation in international courts ▪ Cost of remunerating population ▪ Cost of work stoppages due to local strike, reputation damage, community protests, work stoppages *Reputation-Related:* ▪ Cost of hiring community relations manager ▪ Cost of managing activist NGO relations	$..... $..... $..... $..... $..... $..... $..... $..... $..... $.....	..... %	$.....
Reputation Costs, including lost sales and profits					$.....
				NPV	$.....

SCHEDULE B | **COSTS OF POLITICAL R ISKS**

Risk	Benefit	Cost types	Costs	Likelihood	Expected Value
Changes in legislation that change the rules of the game	$.....	▪ Lost revenues ▪ Increased taxes and tariffs	$..... $..... $.....	..... %	..... %
Forced contract renegotiation with host government	$.....	▪ Lost profits ▪ Lost investment	$..... $..... $.....	..... %	..... %
Armed Insurrection	$.....	▪ Cost of hiring private security ▪ Cost of training local police/military to prevent human rights abuses (if required to use these forces by contract)	$..... $..... $.....	..... %	$.....
Associated Reputation Risk		▪ Cost of incentive packages to attract workers to location ▪ Cost of protests, etc. due to potential linkages with human rights abuses	$..... $..... $.....	..... %	$.....
Endemic corruption	$.....	▪ Costs of payoffs and bribes ▪ Costs of potential lawsuits for that activity ▪ Cost of lost contracts for refusing to engage in that activity	$..... $..... $.....	..... %	$.....
Targeted criminal activity	$.....	▪ Costs of protecting personnel, including extra security, reinforcing security at private homes, providing security training to employees and families ▪ Costs of attracting workers, including increased pay, time off and hardship bonuses ▪ Costs of increased security to protect facility ▪ Costs of potential work stoppages	$..... $..... $.....	..... %	$.....
Terrorism	$.....	▪ Costs of reinforcing infrastructure ▪ Cost of hiring additional security personnel ▪ Cost of rebuilding	$..... $..... $.....	..... %	$.....
Reputation Costs, including lost sales and profits					$.....
				NPV	$.....

identify, measure, monitor, respond to, and report on risk, as well as formulating methods to avoid or mitigate identified risk. As outlined in the identification section, risk identification occurs through internal analysis, evaluation of information from risk firms, and stakeholder analysis. Effective management calls both for monitoring of political and social risks, and communication to management of changes in their levels. Monitoring does not have to be exhaustive—it can involve selecting certain indicators, such as advertising campaigns about child labor, for observation.

Responding to social and political risk can happen in four ways:

- Insuring against risk when possible;
- Avoiding risk;
- Mitigating risk; or
- Some combination of these.

◆ ***Political risk insurance***

Both public sector bodies and private firms offer political risk insurance, in use since the 1970s. Public sector insurers such as the World Bank and government-backed plans seem to have proven a useful deterrent to host governments interfering with investments—the World Bank's Multilateral Investment Guarantee Agency (MIGA) has paid out a political risk claim only three times in its eighteen year history.[17] This low rate of payout is due to a number of factors:

- MIGA does significant due diligence on insurable projects and the political environment before offering a guarantee. Presumably, it has identified and mitigated many potential risks before underwriting;
- Countries are members of MIGA, and the organization always requests government approval before issuing a guarantee for a project in their country. Presumably, the government's approval indicates that it is fundamentally happy that the investment is meeting some part of its development agenda, hence making the investment "safer" from adverse government attention in the future;
- MIGA has some influence with governments, by virtue of its membership in the World Bank Group, and so is able to work with clients and governments if a potential claims situation emerges, to try to reach an amicable solution for all parties, to avoid a claim.

Political risk insurance plans usually insure against: (a) confiscation, expropriation or naturalization; (b) currency inconvertibility; (c) property destruction; (d) business interruption and other disruptions associated with war, terrorism, and other civil disturbances; (e) contract frustration. Likewise, Export Development Canada (EDC), a crown corporation of the Canadian government and the Overseas Private Investment Corporation (OPIC), a U.S. government agency, offer political risk insurance to Canadian and American companies, respectively. Private firms like Marsh & McLennan and Aon also offer protections for potential losses due to expropriation, currency inconvertibility, and war. Exhibit 11 illustrates the risks covered by Aon political risk insurance.

Political risk insurance is, however, of limited use. Sometimes the market cannot or will not cover the investment because it is simply too large, as in the case of some major infrastructure

Exhibit 11: Risks Covered by Aon Political Risk Insurance[18]

- Confiscation, expropriation / nationalization of holdings / fixed or current assets, including "creeping expropriation" and selective discrimination;
- Cancellation, suspension or withdrawal of concession permits, exploration licenses or operating licenses;
- Deprivation of rights to own and use an asset, including cancellation of re-export licenses;
- Deprivation of collateral held as security for loans;
- Forced abandonment or forced divestiture;
- War, terrorism, sabotage and other forms of political violence;
- Foreign exchange restrictions;
- Breach of government undertakings on which the investment was predicated.

17. Judith Pearce, Lead Operations Officer, MIGA. Discussion with author, April 2006.

18. Aon political risk insurance for investment. <http://www.aon.com <accessed January 2006>

projects. Even when coverage can be obtained, however, it is usually limited to risks that are "quantifiable and provable," and presumably insurers have a way to limit claims so defined.

◆ *Avoid Political & Social Risk*

Another method of dealing with political and social risk is to avoid it, either by making pre-emptive risk mitigation plans, or by deciding not to undertake a project whose risk-return ratio is too low. When Shell and Mobil Oil were considering a liquefied natural gas concession in Peru's Lower Urubamba Valley, one of the world's most biologically diverse regions, they engaged in extensive discussions with the government, local indigenous tribes, local environmental groups, and international advisors. As a result, the companies developed plans adapted to local conditions, but nonetheless decided to withdraw because of combined local and international opposition to the project and disputes with the government.[19]

◆ *Mitigate Social & Political Risk*

Another option is mitigation. In this alternative to managing social and political risk, creative solutions are devised to lessen the cost of a risk's impact and/or to diminish the likelihood of the risk emerging. While designing solutions to diminish risk, it is useful to refer back to the potential sources of risk outlined in Exhibit 7. Understanding these sources and what motivates them will allow managers to devise targeted solutions.

For example, a firm with operations in South Africa is faced with a growing number of employees who are becoming symptomatic and dying of AIDS. The company has decided that the prospect of moving its operations to another location is unattractive for business reasons. It is therefore forced to bear a large overhead cost due to absenteeism, high turnover, and the need to consistently train new skilled personnel for jobs left open because of AIDS-related deaths. In the long-term, the company projects that this problem will only get worse—as the AIDS-related mortality rate in South Africa grows exponentially, the company assumes that the rates within the company will too. Understanding that the risk is a social one, generated by lack of awareness, education, and perhaps social stigma associated with the illness, may allow the company to devise location-specific solutions to address the risk.

When strategizing how to mitigate the risk from HIV/AIDS, a business can consider a variety of alternatives. One option is to do nothing, leaving the risk unmitigated. Another is to try to mitigate the risk once it has materialized, by establishing a variety of programs such as workplace education, condom distribution at work sites, voluntary HIV testing at facilities, and medical treatment for workers and families. A firm contemplating entering the South African market could also entertain a third choice, pre-emptive mitigation. In this case, the company would undertake risk-reducing programs mentioned previously as part of the market entry strategy, instead of waiting for the risk to emerge and affect its business.

Exhibit 12 illustrates these three approaches, first one that calculates the estimated value of the project with no mitigation (the base case), then pre-emptive mitigation, and finally mitigation when the risk has materialized:

- **No risk mitigation:** This base case option analyzes the impact of not taking any action to address or mitigate risk. Calculations include the operation's value and the impact of risk on the operation:

Operation Value $_{\text{Unmitigated Risk}}$ =
(Operation Value) + / – [(Political/Social Risk costs) x (%likelihood)]

- **Pre-emptive mitigation:** This option analyzes the impact on the operation if the risk were to be mitigated before it emerges. Calculations include: the operation's value, the expected cost of implementing mitigation programs, projected long-term savings from those mitigation programs, and any reputation value they produce. Note that some risk still exists, even with pre-emptive mitigation, but this will likely result in a lower cost than if no mitigation were undertaken, because programs are commenced before the risk emerges. This does not imply that there will be zero risk-related cost; rather that both the likelihood of risk emergence and the associated cost will likely be lower:

Operation Value $_{\text{Preemptively Mitigated Risk}}$ =
(Operation Value) + / – [(Lowered Political/Social Risk costs) x (lowered % likelihood)]
– [Mitigation Program (Savings – Costs)] + (Net Change in Reputation Value)

19. James Grimaldi. "Texas Firms Line Up U.S. Aid in Peru: Gas Project's Damage to Rain Forest Assailed," *Washington Post*. November 20, 2002.

EXHIBIT 12: Calculating Mitigation Strategies for Social and Political Risk

A UNMITIGATED RISK FOR ONGOING OPERATION

		Project Value	$.....
RISK	**COSTS**	**LIKELIHOOD**	**(-) EXPECTED COST**
HIV increasing among personnel resulting in employee illness and death	• Cost to replace personnel • Cost to re-train personnel • Personnel turnover inefficiencies	..... %	$..... $..... $..... $.....
		Reputation Value (-)	$.....
		Risk Reduced Total Operation Value	$.....

B PRE-EMPTIVE RISK MITIGATION FOR ONGOING OR NEW OPERATIONS

		Project Value	$.....
LOWERED RISK	**COSTS**	**LIKELIHOOD**	**(-) EXPECTED COST**
HIV increasing among personnel resulting in employee illness and death	• Cost to replace personnel • Cost to re-train personnel • Personnel turnover inefficiencies	..... %	$..... $..... $..... $.....
MITIGATION PROGRAMS	**COSTS (+)**	**SAVINGS (=)**	**EXPECTED VALUE**
• condom distribution at work sites	$.....	$.....	
• HIV testing at facilities	$.....	$.....	
• medical treatment for workers & families	$.....	$.....	$.....
		Mitigation-Gained Reputation Value (+/-)	$.....
		Mitigated Risk Operation Value	$.....

C MITIGATED RISK FOR ONGOING OPERATION

		Project Value	$.....
RISK	**COSTS**	**LIKELIHOOD**	**(-) EXPECTED COST**
HIV increasing among personnel resulting in employee illness and death	• Cost to replace personnel • Cost to re-train personnel • Personnel turnover inefficiencies	..... %	$..... $..... $..... $.....
MITIGATION PROGRAMS	**(-) COSTS**	**(+) LT SAVINGS**	**(-) EXPECTED VALUE**
• condom distribution at work sites	$.....	$.....	$.....
• HIV testing at facilities	$.....	$.....	
• medical treatment for workers & families	$.....	$.....	
• Move families together so men not separated	$.....	$.....	
		Mitigation-Gained Reputation Value (+/-)	$.....
		Preemptive Mitigation Operation Value	$.....

Changes in the likelihood and the costs associated with the risk can occur during mitigation, requiring additional calculation.

- **Mitigating risk when it has materialized:** This option analyzes the impact on the operation if a mitigation strategy is undertaken after the risk has presented itself and had an impact. Calculations include the operation's value, the impact of risk on the operation, the cost of undertaking one, several or all of the mitigation programs, and the long-term savings these would generate. Another impact that should be included is any positive impact on reputation from a mitigation strategy:

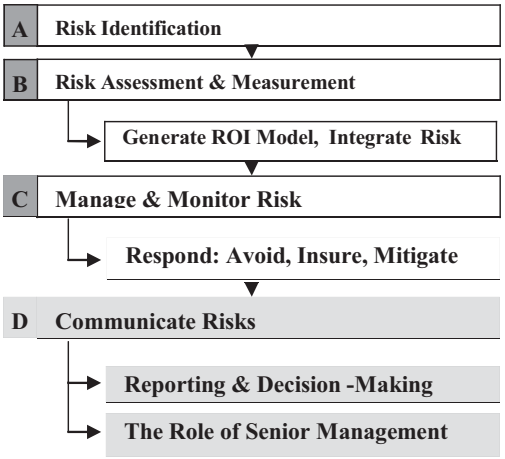
Operation Value $_{\text{Post-Materialized Mitigated Risk}}$ **=**
(Operation Value) + / – [(lowered Political/Social Risk costs) x (lowered % likelihood)]
– [Mitigation Program (Savings – Costs)] + (Net Change in Reputation Value)

These also can create changes in costs and likelihood, again requiring further calculation. The results of these calculations can then be compared for cost efficiency on a net present value basis. Pre-emptive mitigation strategies, often the same actions as post-emergence mitigation activities, will frequently lower the likelihoods and costs beyond those that could be realized from undertaking mitigation after a risk has emerged. Exhibit 12 illustrates these three approaches.

Day-to-Day Operations versus Capital Investment Planning

In addition to the process outlined in Exhibit 12 for ongoing operations, considering the three options can be helpful when evaluating capital investment decisions and comparing various possible locations. In these cases, it is useful to gather risk data on all of the most likely operational locations, and determine the likelihood that risks will emerge for each. Doing this allows managers to compare various locations, understand the most relevant and dangerous risks in each location, and include them in decision-making to determine the best alternative. In addition, by thinking through the costs of the risks and generating pre-emptive mitigation strategies, decision-makers can determine whether it is in their best interest to wait for the risk to emerge, or to incorporate programs into the project design that would mitigate risk at the outset.

IV. COMMUNICATING SOCIAL AND POLITICAL RISK



REPORTING AND DECISION-MAKING

Successful corporate management of social and political risks is predicated on integrating such risks into management systems, and on effective communication both within the firm and with external stakeholders. Employees at all levels must be apprised of senior management's commitment, for better inclusion of social and political risk into decision-making. In addition, management should communicate (a) information about the company's approach to risk, (b) how it defines social and political risk, (c) the potential consequences of risks if they are left unmitigated, and (d) means of reporting on potential hazards. Internal communication can be undertaken during trainings, via the company's intranet, in company manuals, and through focused bulletins.

It is also critical to establish appropriate company and project internal reporting mechanisms for employees to report on risk. An internal reporting system is particularly useful for collecting data on risk in the "identification" stage outlined in this paper. However, to avoid relying on employees to contribute risk-related information, specific risk management personnel should be identified to be alert for risks, so as not to side-line the risk issue. Personnel can either be hired specifically for a risk management function, or cross-functional teams can undertake the work, staffed with individuals from various departments tasked with this responsibility.

As outlined in Epstein and Rejc (*Reporting of Organizational Risks*, 2005), organizations are

recognizing the need for broader internal and external risk reporting—for enlightened internal decisions and for improved analysis and better decisions of external stakeholders. However, standardized general templates for broad risk reporting do not exist.

Reporting social and political risks in monetary terms is, however, an important part of integrating these issues into financial planning. In so doing, these risks climb from their current position as a mere footnote to the financial calculation, to a position that accurately reflects the devastating impact they can have. Transforming the discussion of political and social risks from a largely qualitative to a quantitative one emphasizes their relevance. Although quantifying social and political risks is often imprecise, it is the first step to integrating a wider set of risks into calculations that will more accurately reflect the true nature of risk in an increasingly interconnected world.

Internal Reporting

Internal reporting on social and political risks is critical to sound decision-making and risk management. Boards of directors, risk management committees, and senior managers need timely information about the effectiveness of internal controls, as well as risks, including social and political ones.

- Boards of directors have responsibility for overseeing the development and implementation of the company's mission, values, and strategy. This includes careful review of processes of risk identification, monitoring, and management (Epstein and Roy, 2002).
- Risk management committees' oversight requires a substantive understanding of corporate risks and internal controls. Their duty is to review and evaluate the effectiveness of the company's process for assessing risks, and the steps that management is taking to monitor and control those risks. Doing so requires the committee to receive, review, and consider both broad risk reports as well as issue- or project-specific ones (Epstein and Roy, 2002).
- Senior management's need for information regarding organizational risks is of particular importance. Senior management needs relevant, accurate, and reliable real-time risk reports for effective decision-making and control. Without proper internal reporting on organizational risks—strategic and operational ones, in particular—senior and other managers cannot make the best strategic and tactical decisions. Only by generating both a broad understanding and analysis, supported by targeted, specific and detailed schedules of risk-related information, can organizations inform senior managers and other decision-makers with facts, not intuition. They can then appropriately integrate those risks into more effective management decisions that advance the organization's strategy and goals.
- Employees want safe and secure working conditions, as well as corporate financial stability, and are interested in what may jeopardize both. In addition, as members of the community-at-large, they are often interested in the company's impact beyond the workplace.

Reporting on social and political risks should be integrated with communication on other risks, including the compliance, reporting, strategic, and operational risks outlined in Exhibit 1. Particularly when reporting is aimed at (a) risk managers, (b) the risk management committee, (c) the CFO, and (d) if the results are serious enough, the CEO and the board, discussion of social and political risk should include:

- An outline of current risks faced by the firm, the projected likelihood of occurrence and their potential costs;
- The source of these risks; and
- Mitigation strategies, their potential costs, and the management plan if that strategy is undertaken.

However, internal risk reporting that leads to dysfunctional behavior of different internal audiences, such as a reduction in appropriate risk-taking of managers that is necessary for business success, can impose costs on the organization.

External Reporting

Increasingly, shareholders and other stakeholders are aware that disclosing only current financial risks—market and credit risks—does not provide sufficient information about organizational and financial performance, because these are also affected by other risks, including social and political ones. Although external reporting is not mandatory, some parties that may be interested in a deeper knowledge of a company's risks include: auditors, regulators,

shareholders, creditors, financial analysts, customers, suppliers, consumers, and the media. After identifying, assessing, and possibly responding to social and political risks, companies must decide whether they should be reported externally and, if so, to whom and at what level of detail. Report content will vary with the user.

When contemplating external risk reporting, however, potential costs must be weighed. Voluntary disclosures should therefore be subject to careful cost-benefit analysis. The primary potential costs of external risk reporting are believed to be: (a) competitive disadvantage from informative disclosure, (b) bargaining disadvantage from the disclosure to suppliers, customers, and employees, and (c) unmerited lawsuits attributable to disclosures. The greater the level of detail about a specific risk, the greater the likelihood of competitive disadvantage. Thus, some enterprises may wish to undertake a cost-benefit analysis regarding how much information on social and political risk to report externally. The timing of a disclosure also affects its potential for competitive disadvantage, because at some stage disclosure loses its capacity to create competitive advantage. (Epstein and Rejc, 2005). In their Management Accounting Guideline, *The Reporting of Organizational Risks for Internal and External Decision-Making,* Epstein and Rejc outline a method for a cost-benefit analysis for reporting, as well as modes of data presentation, so that risks can receive proper consideration while not causing undue alarm.

The role of senior managers

Senior financial managers play a critical role in measuring, managing, and reporting social and political risks. In addition to signaling the importance of the issue to all levels of the company, senior management, boards of directors (and audit committees), and various other financial stakeholders need the information generated by quantified social and political risk analysis to better understand and manage the risks facing the company.

Inclusion of social and political risks plays a critical role in due diligence regarding both internal and external decisions. Understanding the potential threats from political and social issues in ongoing operations can mean the difference between being pre-emptive and resilient when faced with catastrophe, or being caught unaware, with potentially tremendous negative effect on revenues or costs. Likewise, appreciating that social and political risk may materialize, and understanding the resulting hidden costs to the company is critical in due diligence for major investment decisions. When undertaking acquisitions and mergers, these risks are also a factor that should not be ignored.

That said, a financial professional must provide a complete and fair presentation of organizational risks without being seen as alarmist, and thereby causing a reduction in appropriate risk-taking that is necessary for business success. To this end, integrating social and political risk into financial calculations allows for comparison with other risks, putting them in a context so that they can be understood along with other challenges. Measuring a project's attractiveness by including social and political risks into its economics is not the intended end point of the methodology outlined in this MAG. Rather, measurement is only one important component in a project review that must include dialogue about the levels of risk and the likelihood of its emergence. The project analysis must be shaped to provide background and generate discussion on ways to manage risks, as well as alternatives that could shift the trade-off between risk and return.

CONCLUSION

In an increasingly globalized world, integrating social and political risks is critical to effective management of a company's real risks, and to improved resource allocation. This demands the quantification of social and political risks in an atypical manner. To account for these risks, they must be identified, measured, monetized, and included in ROI calculations. Social and political risks that can devastate a company's operations can be adequately accounted for, rather than being relegated to a footnote to financial calculations in the hopes that the risks will not emerge. Measurement of social and political risks also enables decision-makers to devise mitigation strategies, sometimes pre-emptively, that can produce significant cost savings. This Management Accounting Guideline provides a method to include social and political risks in financial calculations, and to integrate them into overall risk management for improved decision-making.

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APPENDIX 1: REAL AND PERCEIVED RISK

Factoring in the stakeholder perspective allows social and political risks that companies face to be separated into real and perceived risks. Stakeholder reactions to an issue can transform their perceptions of a company's involvement with a matter of concern (perceived risk) into a real risk for the company, and increasing a company's costs. Real risk includes all social and political issues that (a) result from business activities, and (b) external actions (like nationalization of industries) imposed on the company that affect its business. Perceived risk includes all issues that stakeholders, including consumers, employees, and communities hold a company responsible for, whether or not evidence supports the perception.

It is important to identify real and perceived risks, and their sources, to better manage them. Both real and perceived risks carry financial costs to the company and can cause significant reputation risk. Real and perceived risk can be combined in three ways:

- **Real and perceived:** risks created by a company's actions that lead to a reaction from affected constituent, or risks generated by a social or political issue that directly affects a company's profits.
- **Real and not yet perceived:** risks created by a company's actions that affect some constituents, but who are not yet aware of it and therefore have not yet reacted. Some of these may not be perceived by the company or society at large for some time. In the short-term the risk is real, but may have no immediate effect or cost. Once stakeholder perceptions change, however, either through greater information or shifting sensitivities, the risk to society manifests, and the reaction to it can lead to significant costs for the company. Sometimes the stakeholders identify the risk before the company does, and the company is taken by surprise, with very negative consequences. Coca-Cola worked in Kerala, India for years. Its water use was not recognized as an issue by the company, by its stakeholders, or by the public at large. Then, in the mid-1990s, members of fifty villages surrounding Coca Cola's bottling plant claimed that the company was siphoning off drinking water and depositing waste with high cadmium and nickel content in the surrounding areas. Soon international activists joined in. Although the outcome of the legal battle was settled in Coca Cola's favor, information about the issue has spread quickly to both North America and Europe, sparking anti-Coke protests. As a result of the ongoing lawsuits, trouble with the local community, and worldwide protests, Coca-Cola weighed the revenues produced by doing business in Kerala against the cost to its reputation worldwide, and decided the price it was paying was too high. As a result it decided to leave Kerala.

  Coke's experience illustrates that in an age of 24-hour news, the Internet, and text messaging, information can spread across the globe, mobilizing people and leading to negative impacts on reputation. Activists today can use the Internet to spread information, whether it is factual or not, within seconds. Twenty years ago, information was passed by mail or by telephone from one person to another person. Today, activists' global reach and connection to one another across vast distances, coupled with high public trust in the non-governmental organization (NGO) sector, make it much easier for activists to attack companies and put them on the defensive. This makes it more difficult for companies to deal with and react to risk situations, particularly ones generated by perception. Some risks, like Coca-Cola's water use in India, are, in the short-term, not risks at all, because they are not presently noticeable to stakeholders. However, these issues have the potential for long-term damage to reputation when the risk materializes or perceptions change.
- **Perceived and not real:** the company is perceived, because of its business practices, location, reputation, or targeting by activists, to have caused damage or created a risk to society, even though it has not. The company is held to account because various stakeholders react through, for example, customer boycotts, strikes by workers, etc. These reactions in turn create a risk and a cost to the company. Shell's 1995 Brent Spar experience is a case in point. The company decided to dispose of its decommissioned oil platform by sinking it in the North Atlantic. In response, Greenpeace activists carried out intensive campaigning in Northern Europe, claiming that Shell was being environmentally irresponsible, and that sinking the Brent Spar would dump 5500 tons of oil in the sea, wreaking havoc with the environment. In

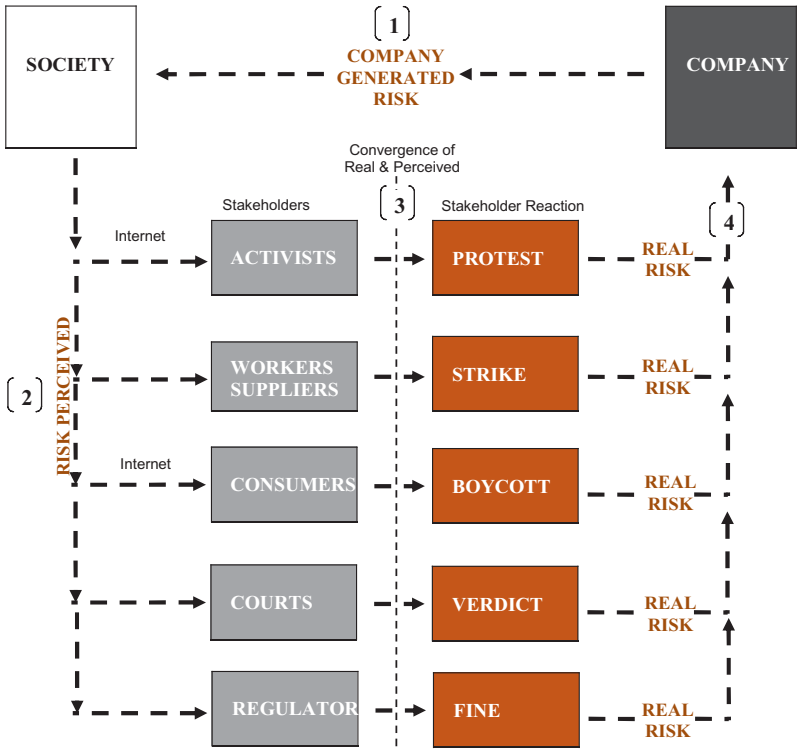
addition, 25 activists occupied the platform and the organization encouraged boycotts of Shell stations that resulted in some violent attacks and threats to Shell workers. In the face of falling sales and a drop in share price, the company commissioned a third party to investigate Greenpeace's allegations, which were later acknowledged to be inaccurate, leading to an apology by the activists to Shell. Shell suffered substantial losses from the Brent Spar incident, because of lost sales, reputation damage, time by management dedicated to managing the incident, other internal company resources applied to the issue, and the cost of the diversion from ongoing operations. Reputation risk is further discussed in a later section. The costs resulting from the Brent Spar incident occurred as a result of perceived risks to the community, rather than actual ones. It is important that companies effectively manage both the perception that their activities pose a risk to society, and any actual or real risks their operations may create. Both of these can create costs for the company.

Company-generated risk to society, or society's perception that a company is causing a negative impact, can create a feedback loop. In such a feedback loop, illustrated in Exhibit Appendix 1, the company's activities create a risk to society [1] (or society believes that business operations are having a negative impact); members of society, the company's stakeholders, become aware of this risk through various means including the Internet [2]; these stakeholders react to the identified risk by protests, strikes, boycotts, adverse legal verdicts, or fines [3]; and these stakeholder reactions create real risks to the company's ability to do business [4].

Risk generated from perception, here called perceived risk, can represent an equal or greater threat to the company than risk generated by real social and political issues, since the consequences can be as dire and the costs as high. Although liability for real risk may be expressed through fines and the cost for tasks like environmental cleanup, accountability for perceived risk can be expressed through lawsuits and boycotts, both of which have real costs.

Differentiating between real and perceived risks is, therefore, critical to identifying potential hazards, thinking through their prospective impacts, and designing mitigation techniques. A manager weighing the consequences of the various options must factor public opinion, even if it is based on erroneous information, into decisions about the best course of action. The potential costs of both real and perceived risks are very high.

Exhibit Appendix 1: The Real and Perceived Risk Feedback Loop



APPENDIX 2: POLITICAL RISK CONSULTING FIRMS AND THEIR OFFERINGS[20]

CONSULTING FIRM	SCOPE	SERVICES OFFERED	PRODUCT
Control Risks Group	Global	• Political and security risk analysis • Security consultancy • Crisis management and response • On-line risk assessment service • Country Risk Forecast measuring the impact of political and security developments on businesses and business activities	• Impact-likelihood matrix to measure 8 aspects of risk • 120 Country Risk Forecast: analysis of political, security and travel risks, ranked extreme, high, medium, low or insignificant
The Economist Intelligence Unit	Global	• Country analysis • Forecasts • Risk assessment • Economic and market data • Industry trends	• Reports • Market Indicators and forecasts
Eurasia Group	Asia, Latin America, Europe, Eurasia, Middle East, Africa	• Country analysis • Forecasts • Risk assessment • Economic and market data • Trends in global energy, homeland security, bio-security	• Political stability index, produced with Deutsche Bank • Publications • Consulting
Kissinger McLarty Associates	Global	• High-level intervention regarding special projects, assist clients to identify strategic partners and investment opportunities, and advise clients on government relations	• Strategic advisory services • Advocacy services
Political Risk Services Country Forecasts	Global	• International Country Risk Guide provides assessments of political, economic, and financial risk based on analysis of worldwide experts, subject to a peer review process	• Assess 12 components of political risk (military in politics, democratic accountability, internal conflict, government stability, bureaucratic quality, investment profile, law and order, corruption etc.), • 5 components of economic risk

20. Adapted from: Campbell, A and David Carmet. "The Private Sector and Conflict Prevention Mainstreaming: Risk Analysis and Conflict Impact Assessment Tools for Multinational Corporations." Carleton University, May 2002.

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