

## SOURCES OF REPUTATION CRISIS AND POSSIBILITIES OF ITS MANAGEMENT

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**Abstract:** Reputation is a very valuable, strategic resource of a contemporary company. It is a prized but simultaneously highly vulnerable, corporate asset and at the same time one of the most difficult to protect. No company is able to protect itself from committing some errors and avoiding the risk of reputation loss or damage. Although it is not possible to eliminate reputation risk, it is possible to limit the probability of a crisis and the influence of its effects. It requires monitoring and control of the factors as well as the sources of risk and protection of procedures and tools which could be launched immediately after occurrence of an undesirable event. So this is what the management of reputation risk is about. As an example companies that identified the sources and was able to deal with the reputation's crisis is Toyota.

**Keywords:** corporate reputation, stakeholders, reputation risk, crisis management.

### 1 Introduction

Reputation is considered to be one of the most valuable resources of a modern company. It is classified as an intangible resource, included in marketing resources of relational nature [Hooley, Saunders, Piercy, 1998; Srivastava, Shervani, Fahey, 1998]. Reputation has a nature of strategic resource because according to the conception of resource school, it belongs to the resources which are valuable, rare and impossible to imitate [Barney, 1991; Grant, 1991; Hall, 1993]. Strong, positive reputation, carefully sustained and nurtured can be the source of a long-term competitive advantage of the company [see: Szwajca, 2012].

Difficulty or relative impossibility to manage reputation results from its complex and specific nature. J. Low, and P. Kalafut notice that reputation is the ultimate intangible, it is slippery, volatile, easily compromised, amorphous and impossible to control [Low, Kalafut, 2002]. But some authors claims, that we should rather talk about management of reputation risk.

This paper has a number of objectives:

- to realize the role of corporate reputation, as a significant marketing resource in today's competitive arena, and to indicate how difficult it is to manage this resource,
- to present identification of possible reputational risk sources, with particular attention to predictable and unpredictable sources,
- to describe the possible approaches to reputation risk,
- to present a case study of a company that identified the source and was able to deal with the crisis reputation.

### 2 Is it possible to manage corporate reputation?

In general, reputation can be defined as an opinion functioning on the market about the company and its activities expressed by different groups of interest (so-called stakeholders) who had any kind of contact with this company or heard about it. Corporate reputation is also defined as:

the "observers" collective judgments of a corporation based on the assessment of the financial, social and environmental impacts attributed to the corporation over time [Barnett, Jermier, Lafferty, 2006],

the perception of a corporation by the public (including corporation's various stakeholders such as suppliers, customers, employees, local communities etc.) and is a function of certain events exposing corporate identity features (such as business practice, behavioral incident or characteristics of the sold products) that were previously unknown to the public [Tonello, 2007].

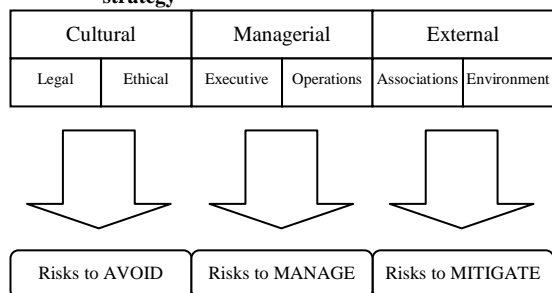
Good reputation is the source of numerous benefits: it builds and enforces customers' loyalty, it allows to gain the best employees, attracts attractive investors, facilitates establishing relationships with the best suppliers and contractors [Walker, 2010; Obloj, Obloj, 2006; Eccles, Newquist, Schatz, 2007; Rayner 2003]. These benefits can be translated into measurable results in the form of increased sales, lower marketing costs, lower capital costs, higher profits and higher growth potential. It is reflected in financial results and market value of a company [Roberts, Dowling, 2002; Fombrun, van Riel, 2004]. B. Lev estimates that corporate reputation can comprise more than 60 per cent of a company's value [Lev, 2001]. Wang and Smith found that having a higher reputation on average increases the company's value by about \$1.3 billion [Wang, Smith, 2008]. Institutions and agencies dealing with the measurement of reputation (e.g. Reputation Institute, Harris Interactive, Fortune) proved that there is a strong positive correlation between the Reputation Quotient and market value of a company. For instance, according to the research of the Reputation Institute a positive 1-point increase in the Reputation Quotient was associated with higher average market values of about \$147 million, while a 1-point decrease was associated with market values lower by about \$5 billion. These results suggest that a "value spiral" operates according to the rule that better-regarded companies attract more investors who build up their market value and further improve their reputation [Fombrun, Foss, 2001].

Reputation is a valuable resource contributing to the company's value but at the same time it is very sensitive, prone to injuries and difficult to protect. It takes a lot of time to build it but it can be lost at once. W. Buffet said that: "It takes 20 years to build a reputation and five minutes to ruin it." Firestein said that today a risk to its reputation is a threat to the survival of the enterprise [Firestein, 2006]. Of course not every mistake or crisis in a company results in complete loss of reputation and leads to its collapse. In most of the cases reputation is damaged or impaired but it can be rebuilt. However, it turns out that it is a very difficult challenge for the companies. It may be costly and extremely lengthy.

In connection to the fact that reputation is a very complex, sensitive and difficult to control resource, a question arises whether it can be effectively managed [Szwajca, 2011]. Some authors suggest that we should rather talk about management of reputation risk, understood as a gap between the expectations of stakeholders and company's operations [Ross, 2005; Honey, Brady, 2007; Tonello, 2007; Honey, 2009]. However, according to Eccles, Newquist and Schatz most of the companies do not manage reputation risk because managers do not know how to define and measure it. In practice their operations come down to liquidation or mitigation of the negative results of the crisis which surprised them suddenly. It is not risk management but crisis management [Eccles, Newquist, Schatz, 2007]. Although it is not possible to eliminate reputation risk, it is possible to limit the probability of a crisis and the influence of its effects. It requires monitoring and control of the factors as well as the sources of risk and protection of procedures and tools which could be launched immediately after occurrence of an undesirable event. So this is what the management of reputation risk is about.

### 3 Sources of reputation risk and management strategies

The causes of situations leading to damages or loss of reputation can be located inside or outside of the company. Internal causes are connected with behaviors and decisions of the employees at the different levels of organizational structure – from a regular employee to the chief executive manager. External causes are objective in nature and do not completely depend on will and human activities. Honey and Brady classified the sources of reputation into three groups, indicating appropriate operational strategy for each of them (figure 1).

**Figure 1. Sources of reputation risk and management strategy**

Source: Own work based on: Honey G. (2009), *A short Guide to Reputation Risk*. Gower Publishing Limited, England-USA, p. 24.

Cultural risk is rooted in organizational culture of a company, therefore it refers to adherence to codes and standards of conduct, procedures and rules of operation, valued merits, customs and traditions. Cultural risk embraces legal and ethical risk. In case of legal risk the rules and regulations of conduct are imposed by external institutions (central and local administrative authorities, tax offices, supervision committees etc.) – failure to adhere to these rules results in rigidly defined legal sanctions. It is the most dangerous type of risk which in most of the cases leads to the collapse of a company. The best known examples are here Enron and Arthur Anderson [see: *Najgorsze strategie i praktyki zarządzania*, 2008].

In reference to ethical risk, rules are established and adopted voluntarily by an organization or discreetly imposed by various opinion forming environments (e.g. social organizations, business associations, research centers, mass media). Ethical risk reflects discrepancy between this what an organization says and what it actually does. A good example here can be promises made in advertisements which are not kept or ethically controversial advertisement. Since the sources of cultural risk are relatively easy to identify, the company may apply towards them the strategy of avoidance.

Management risk refers to the sphere of decision-making and performing tasks by all employees of a company – from the highest to the lowest level. Management risk referring to the decisions made at the highest level are reflected in the results of a company as a whole (level of profit, stock rate, shares in the market etc.). These are usually wrong strategic or investment decisions, resulting from the lack of competence or arrogance of the executives. Operational risk in turn, is a consequence of mistakes or negligence of the executives at the lower levels or direct contractors. Their mistakes in most of the cases lead to the defects of a product, mistakes in documents or faults in service etc. It is possible to mention here such examples as: J&J's Tylenol – a painkiller intoxicated by cyanide, faulty Firestone tires, defect of Pentium chip by Intel Corporation [see: Hartley, 2004; Krawiec, 2009]. The sources of management risk can be identified and controlled that is why the best strategy is the management of risk. Companies use different tools in the form of early warning system, controlling or procedures of internal audits. However, they do not give any guarantee to avoid this risk since none of the procedures can protect against human error.

Determinants of cultural and management risk are placed inside an organization. There are also some which are in its environment. These are external factors which can be divided into two groups: relational and environmental. The first group of factors is connected with the fact that a company uses outsourcing, cooperates with different entities on the market: suppliers, intermediaries, cooperators etc. Mistakes and errors committed by them (e.g. supply of faulty raw material or component, delay in delivery by external haulage contractor, loss of an invoice) indirectly charge the company because it made a wrong choice, maybe it did not sufficiently verified or checked a potential partner. These factors generate relational

risk. The second group of the causes of external risk is located in natural, demographic, technological and competitive environment of a company. These causes are the source of environmental risk. Such events as: fire of the storehouse, computer virus, emergence of dangerous competitor cannot be predicted or effectively protected. The causes of external risk can neither be controlled nor avoided. The only solution is to reduce or mitigate the results of undesirable phenomena.

#### 4 Toyota – defects in cars

Toyota is one of the most recognizable and best-selling brands of cars in the world. Since 2007 Toyota constantly occupies the first position as regards the most valuable car brand in the world. In the same year it won the title of the biggest manufacturer of cars in the world, taking it after 76 years from American General Motors.

Toyota Motor Company builds its reputation on the basis of high quality and reliability of its products. Such attitude is the foundation of the company's organizational culture which is based on continuous improvement of the quality of production, identification of the areas that can be improved as well as introduction of necessary improvements at the beginning of each new project. However, despite huge efforts connected to building of corporate image as the manufacturer of the highest quality cars, Toyota until the year 2009 underwent several crises related to reputation.

The first crisis appeared in November 2009 and referred to the detection of technical defects in certain models produced between the years 2005 and 2009. The problem referred exactly to the blocking gas pedal in eight models of cars. Recall, carried out at the expense of the group, was to correct the floor-mat attachment and possibly adjust its position so it could not interfere with the gas pedal. Another defect was also connected to a gas pedal that became stuck leading to unintended acceleration. In January 2010 it turned out that the cars equipped with defective parts in American factories were also sold in Europe.

In February 2010 another defect related to the functioning of brakes appeared. This time recall referred to over 400 thousand hybrid cars [B. Niedziński, 10th February 2010]. The cause of faulty brake system was in electronics which required reprogramming during the recall campaign. Delay in braking process resulting from faulty brake system constituted a serious threat to the health and life of the drivers as well as the passengers of these cars. Until today no one knows how many people died because of this defect. Toyota admitted to five but American authorities have spoken about 18. There were at least 2 thousand accidents caused by this defect in the United States alone where the problem was revealed at the earliest.

These events seriously damaged Toyota's corporate reputation because the company reacted too slowly to the problems that came into light in its cars. The first defects appeared in November 2009 but 3 months had passed before the company informed its customers about it.

After this issue was reported, the first reaction was an apology of Toyota's president during Economic Forum in Davos where he publicly claimed responsibility for the defects in the cars and spoke about people who lost their lives in consequence of these defects. In February 2010, first in the newspapers in the USA and then in Europe, information appeared about defective cars as well as a full page apology advertisement and information about recall action. Apart from service recall of 8.5 million vehicles, Toyota also made a dramatic decision to suspend production and sales for a week in order to repair the cars at different dealers as well as to collect sufficient number of faulty components. As a result, in February 2010 the company sold 9% cars less in the USA than a year earlier whereas the competitors experienced increased turnover. Moreover, a debate raged in the United States whether Japanese cars were still safe which led to the hearing of Akio Toyoda (the president of Toyota) in the United States Congress where under oath

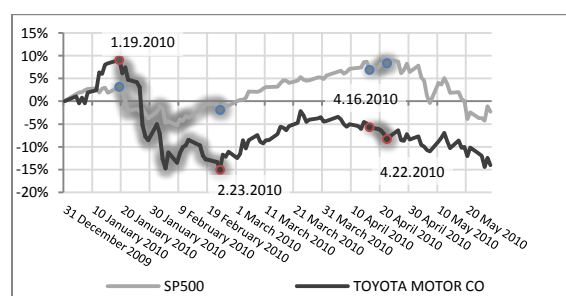
he was answering to Congressmen's questions. The president of a Japanese company admitted that initially his company downplayed the reports that in some models of Toyota gas pedal was blocking. American authorities received reports about 34 possible victims of fatal accidents caused by unintended acceleration problems.

As a result of these events Toyota lost not only in terms of its corporate image, which it had been diligently building over the years, but also in financial terms. It is estimated that corrective actions cost about \$2 billion and included about 12 million cars [B. Niedziński, 10th February, 2010]. The effect was a considerable drop in quotes which from 21st January, when the first information about hidden defects in Japanese cars appeared, to March 2010 caused that the market value fell by \$31 billion.

The management of Toyota, in an attempt to rebuild corporate reputation, took up various steps such as an apology visit of the Toyota's president in Georgetown where the biggest factory of this brand in the USA is located, issuing information about potential threat to safety in certain models on the company's website, making a promise to install a mechanism that would eliminate the risk of a sudden acceleration in all new models of the cars.

The above mentioned steps taken to stop the crisis of reputation show that Toyota felt guilty and did not try to avoid the problem and, on the contrary, it made a step to its customers, trying to provide them with the best service and help. What is more, the company had to pay a record-high penalty (\$32.4 million) for breaking safety rules because it did not inform about technical problems with its cars [D. Walewska, 22nd December 2010]. Toyota's activities, even though together with a further disclosure of information in the media about car defects company's shares on NYSE were marked down more than the index of broad market (S&P500), they were still positively assessed by shareholders which at the end of February led to the return to correlation [Fan, Geddes, Flory, 2013]

**Figure 2. Changes of stock quotes of Toyota Motor Company and the S&P500 index on NYSE on a cumulative basis before and after a crisis event (date of reference: 31st December 2009).**



Source: Own work on the basis of quotes data from [www.yahoo.finance.com](http://www.yahoo.finance.com)

Unfortunately for Toyota, information about the defects in its cars which were revealed in the period of January-February were not the only ones in 2010. On 19th April 2010 this Japanese company, after a headline "Don't buy. Dangerous" appeared in a "Consumer Reports" magazine [A. Kublik, 15th April 2010], announced that it suspended worldwide sales of the new off-road Lexus GX 460 and, moreover, it would suspend for 9 days production of this car. It also promised to conduct car safety tests in all models. Toyota's problems, apart from financial ones, were also related to questioning of Lexus safety – a luxury Japanese brand which for years had been considered to be the highest quality standard in automotive industry. It should be noted that these events negatively influenced Toyota's stock quotes on NYSE (figure 2) but because of the preventive measures that were quickly taken up, the time of this influence was much shorter than in case of crisis situation from the beginning of 2010.

Toyota, after a lesson from the beginning of 2010, adopted the policy to care about corporate reputation which was connected to issuing information about the defects in cars as soon as it was possible and taking up corrective actions [D. Walewska, D. Woźniak, 27th February 2011]. After the crisis at the turn of 2009/2010, further communicates about Toyota's recall were associated with its concern about the quality of produced cars as well as corporate reputation. Crisis which affected the company in 2010 had a nature of operational risk at a fairly high level (safety and even users' lives were put at risk). Corrective actions were not standard – in fact, no action was taken immediately after the crisis. Only after numerous complaints, motions to courts and popularization of the topic by the press which attracted attention of government administration in the USA, the company finally decided to take up corrective actions. It was then that the company decided to take steps to rebuild its reputation. Thus, proper management of situational crisis makes customers are willing to forget and forgive [Coombs, 2007; Hunter, Menestrel, de Bettignies, 2008; Carroll, 2009].

## 5 Conclusions

Reputation risk is inherent in the activities of each and every company. Acceptance of this fact is the first step in the process of risk management. The second step is activation of the early warning system which means tools and procedures to monitor potential sources and causes of risk. It primarily refers to managerial and cultural risk because the causes of environmental risk are more difficult to predict. The third step is to develop a program and the team (of procedures and people) to carry out corrective actions which can be activated immediately after crisis occurrence in order to reduce its negative consequences.

Deep crises are those which sources are cultural causes, especially legal but also ethical. They cause more severe not only financial but mainly image losses. Rebuilding of such reputation is here more difficult and lasts much longer. In extreme cases it is impossible to repair and ends with the collapse of a company. A good example here is Toyota whose actions after the crisis were not immediate but they were effective in the long term.

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**Primary Paper Section: A**

**Secondary Paper Section: AE**