

CGMA<sup>®</sup> BRIEFING

## Rethinking the value chain

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Ethics, risk and governance  
through the extended value chain

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# INTRODUCTION

The boundaries of value creating activities are becoming extended and blurred. There is now greater reliance on alternative forms of sourcing, multiple formal and informal business partnerships and other developments that are reshaping these boundaries. For example, the end-customer might now also be a supplier by providing innovative contributions to new product development.<sup>1</sup>

Globalisation, demographic changes and digitisation are major trends affecting the extended value chain and the first briefing touched on some of the risk implications. These, along with an expanding array of ethical, legal, regulatory, and corporate social responsibility issues comprise the ever-evolving governance aspects of managing the extended value chain.

We identify some of the key questions that boards need to address. We also explore the principles and critical capabilities for building resilience. It is this resilience which enables a company to deal with both the expected and unexpected, while maintaining focus on business goals and capitalising on new opportunities.

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# THE IMPORTANCE OF REPUTATION

The common thread underpinning the ethical, governance and risk aspects of the extended value chain – and a key reason why organisations need to ensure that they take this seriously – is reputation.

Reputation, now more than ever, needs to be an explicit and integral component of managing risk. This is particularly so, given that 80% of the value of an organisation is now represented by intangible assets, including the value of the brand, which can be highly sensitive to reputational impacts.<sup>2</sup> That is why organisations need to focus on third party risk, both through the supply chain and key relationships as illustrated below.

## CASE STUDY

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### McDONALD'S AND THE EUROPEAN HORSEMEAT SCANDAL

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When Paul Pomroy took the reins of the UK and northern European finance function for McDonald's last November, little did he know that the horsemeat scandal would be sweeping the continent within weeks. Given that he had just assumed responsibility for the group's supply chain, he was on high alert as soon as it emerged that British supermarket chains had been selling contaminated products. The fast-food retailer, which has been operating in the UK for 40 years, was given a clean bill of health – testimony to the rigour the company applies to managing its supply chain and no mean feat for a business that serves four million meals a day in the UK alone. In the context of the horsemeat scandal, the company's

reputation for managing its supply chain can only have been enhanced, Pomroy argues. "We believe that food quality begins at the very first stage of the supply chain. All of our raw ingredients meet the highest possible standards of quality and safety. We use 100 per cent British and Irish beef in our burgers – no fillers, trimmings or additives – and traceability is important to us, just as we know it's important to our customers. We are able to track which farm and which herd a certain batch is from. It's the simplicity of our products and supply chain, paired with the long-term nature of our partnerships that play a massive part in this."

*Financial Management, 2013<sup>3</sup>*

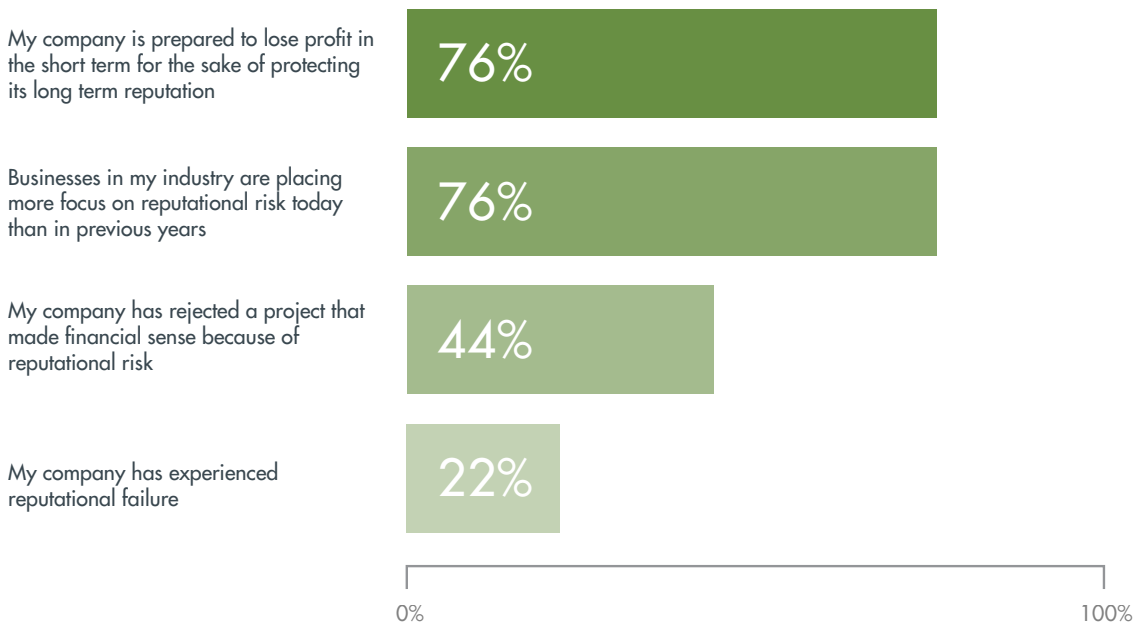
Not surprisingly, a recent global CGMA survey of more than 1,300 finance leaders found that reputational risk is a growing concern and steps are being taken to ensure that the fallout from adverse events does not impact the company's value.<sup>4</sup> Over three quarters (76%) of those surveyed indicated that their company was prepared to lose profit in the short term for the sake of protecting long-term reputation and the same number (76%) are putting more focus on reputational risk now than in previous years.

The survey identified a greater demand for transparency as the leading driver underpinning this change, followed by reputational failure at a leading organisation or competitor. The two are probably connected in that it is corporate shortcomings that have had a major impact on trust in business and have driven responses such as demand for transparency as well as greater regulation, as will be seen in the next section.

A further key driver is the explosion of social media and the enthusiasm of customers, employees, suppliers, advocacy groups and the wider public to take to cyber space to vent their opinions, good or bad. Replay the McDonald's story above in your imagination, but with a less happy ending and then think about how that would have played out on social media. In effect, the organisation's reputation is 'lent' by stakeholders, who can lend you more or call in the loan at any time.

Reputation and the extended value chain are therefore inextricably linked. For example, a study of senior executives at over 100 multinational companies by global legal firm, Baker & McKenzie, found that reputational risk, particularly around corruption, was a greater consideration than cost when selecting partners and suppliers.<sup>5</sup>

FIGURE 1: Reputation risk – a growing concern



Source: CGMA reputational risk survey, 2013

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# THE CHANGING CORPORATE GOVERNANCE ENVIRONMENT

Companies and their boards need to be aware of the growth of legislation, regulatory requirements and social responsibility expectations which have a material impact on the way companies manage their value chains.

Investors are taking an increasing interest in this area, for example, initiatives such as the UN Principles of Responsible Investment have seen growth in membership from less than 200 to over 1000 between 2004 and 2012 with combined assets of over \$30trn. As the initiative outlines, “The impact of poor corporate governance practices on shareholder value, accentuated by the global financial crisis, has also lifted issues such as transparency, corruption, board structure, shareholder rights, business ethics, risk management and executive compensation to the top of the investor agenda.”<sup>6</sup>

A key area of concern is bribery and corruption and the growth in cases under the US Foreign Corrupt Practices Act (FCPA) and the introduction of the UK Bribery Act 2010, both with extra-territorial effects, is having an impact. Many key emerging markets have also revisited their anti-corruption and bribery legislation, reflecting the growing focus on corruption at inter-governmental level through bodies such as the OECD and the G7.<sup>7</sup>

In addition to corruption and fraud, there is also increasing focus on:

- Human rights, child labour
- Health and safety
- Environmental issues
- Conflict resources, (natural resources, extracted from a conflict zone and are used to fund the fighting), for example conflict minerals and ‘blood diamonds’.

These legal and social issues are being addressed through various channels, both legislative and non-legislative, that address corporate conduct and increasingly require corporate transparency with mandates for disclosure. For example:

- First drafted in 1976, the Organisation for Economic Co-operation and Development Guidelines for Multinational Enterprises provide voluntary principles and standards for responsible business conduct. The guidelines are the most comprehensive instrument in existence today for corporate responsibility multilaterally agreed by governments.
- United Nations Global Compact: A strategic policy initiative for businesses committed to aligning their operations and strategies with ten universally accepted principles, in the areas of human rights, labour, environment, and anti-corruption. The Global Compact encourages signatories to engage with their suppliers around the Ten Principles, and thereby to develop more sustainable supply chain practices.
- In September 2013, the UK government became the first to set out guidance to companies on integrating human rights into their operations. Although these do not impose legal obligations, they are increasingly being incorporated into contracts and are drawn from the “Guiding Principles on Business and Human Rights: Implementing the United Nations ‘Protect, Respect and Remedy’ Framework” proposed by UN Special Representative John Ruggie.

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- Section 1502 of the US Dodd-Frank Act requires companies to report to the Securities and Exchange Commission (SEC) on the origins of many precious minerals in their products. The legislation is targeted at conflict minerals.
  - The Bangladesh Accord came about as a consequence of the collapse of the Rana Plaza building near Dhaka in April 2013 designed to improve the safety of workplaces in Bangladesh. It is a legally binding agreement signed by over 150 apparel corporations from 20 countries in Europe, North America, Asia and Australia; two global trade unions, and numerous Bangladeshi unions. It includes independent safety inspections and public reporting of the outcomes of these inspections.
  - A new directive adopted by the European Parliament in April 2014 will require large companies in the European Union to report on non-financial information to improve transparency on social, environmental and diversity matters. Companies concerned will need to disclose information on policies, risks and results as regards environmental matters, social and employee-related aspects, respect for human rights, anti-corruption and bribery issues, and diversity on boards of directors.<sup>8</sup>

## External drivers of Value Chain risk

The extended value chain is also subject to external influences where the risks originate from sources outside the value chain. A more globalised world with more dispersed, complex value chains means these are increasingly important to consider.

These fall broadly into the categories of geopolitical and environmental risks. These include greater incidence of extreme weather events, such as floods, storms and fires as well as profound political and social instability. Both of these featured in the World Economic Forum's ten global risks of highest concern in 2014.<sup>9</sup>

The same report also highlights the risk of 'digital disintegration' and describes a worst case scenario of 'cybergeddon' where the internet would cease to be a trusted medium of communication and commerce. While this represents an extreme scenario, organisations need to factor in consideration of cyber risk in terms of its impact on the extended value chain.<sup>10</sup>

Other risk factors to consider include environmental risks such as resource constraints and the impact of population growth.

While the origin of such external risks may be outside the organisation's direct control and not caused by weaknesses within the value chain itself, the organisation may still be able to influence significantly the impact of such events by effective risk management including close attention to the reputational risk aspects.



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# RISK RESILIENCE IN THE EXTENDED VALUE CHAIN

Against this background, it is not surprising that value chain risk has become a more pressing issue for business leaders.

For example, a Deloitte survey of nearly 600 global manufacturing and retail executives about supply chain risk revealed that 48% had experienced an increase in the frequency of such risk events and they were becoming more costly according to 53% of respondents.<sup>11</sup>

However, there is also increasing recognition that it is simply not possible to identify every possible risk event with the aim of eliminating risk completely. In any case, while risks may originate from many different sources, their impacts on the value chain may be very similar, requiring similar responses. An example of this is ‘closure of airspace’ as occurred after the eruption of the Icelandic volcano, Eyjafjallajökull, in 2010. While many organisations might have struggled to identify such a specific cause of risk, it would be possible to plan for closure of airspace, irrespective of how it was caused, if that was likely to have a material impact on the organisation’s operations.

An emerging, and more promising approach, to managing value chain risk, lies in building resilience. This is based on identifying what Deloitte have termed ‘critical vulnerabilities’ – or chinks in the chain that expose a company to risk in the first place in terms of either probability or impact.

MIT research shows that value chain disruptions have a significant impact on performance: of the 209 companies surveyed, at least 60% reported a 3% or higher loss of value across all the operational KPIs examined.<sup>12</sup> The same research also makes it clear that companies with more mature risk processes are more resilient, experiencing a lesser impact and more rapid recovery.\* In this way, investment in resilience can become a source of competitive advantage as the company that recovers quickly can gain market share while their rivals are still struggling to cope with the operational challenges. In other words, a company might not be able to prevent value chain disruptions from occurring, but it can do a lot to mitigate the potential impacts.

## The Principles of Resilience

It is against this background that recent research, *Roads to Resilience*, by Cranfield School of Management on behalf of the risk management organisation Airmic, has asked what organisations can do to ensure the future success of the organisation against the growing array of risks by building resilience right across their value chain.<sup>13</sup>

The research focused on eight organisations<sup>†</sup> which were found to go far beyond what would be regarded as traditional risk management and recognised that volatile and complex business environments require an original and dynamic approach to risk management.

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\* The research identifies seven enablers of maturity, for example, risk governance, upstream and downstream supply chain integration, the use of data, models and analytics. Companies assessed their maturity levels by matching their practice against these enablers.

† The eight *Roads to Resilience* case study companies are: AIG, Drax Group, InterContinental Hotels Group (IHG), Jaguar Land Rover, The Olympic Delivery Authority (ODA), The Technology Partnership, Virgin Atlantic, Zurich.

## Reputation and resilience

In the eight organisations studied, the traditional tools, techniques and structures of risk management were understood and extensively applied. However, it is clear that these approaches are regarded by management as necessary but not sufficient to achieve the desired level of organisational resilience. Managers perceive risk management to be about protecting and championing the reputation of the organisation and creating resilience. Such organisations are adaptive to change, as they do not just focus on building stronger defence mechanisms. Instead, they build the capacity to deal with both the expected and unexpected, protecting reputation and integrity, while still remaining focused on achieving their business goals. Furthermore, resilient organisations ... are also better placed to recognise and take advantage of business opportunities.<sup>14</sup>

Although the case study organisations were very diverse, the research identified five capabilities or 'resilience principles'. Organisations must have all five to achieve resilience:

- **Risk radar** – the ability to anticipate problems and see things in a different way will help an organisation develop an early warning system and be able to seize new opportunities
  - **Resources and assets** – well diversified resources and assets provide the flexibility to respond to opportunities as well as adverse or changing opportunities
  - **Relationships and networks** – risk information flows effectively both within the organisation and along the value chain
  - **Rapid response** – capability that prevents an incident escalating into a crisis or disaster because people and processes are in place to quickly restore things to normal
  - **Review and adapt** – learn from experience, including near-misses and make the necessary changes and improvements to strategy, tactics and capabilities.
- The resilience principles need to be built by creating a resilient environment through four key enablers:
- **People and culture** – for example, by creating the right culture and risk awareness through training and robust communications channels
  - **Business structure** – for example, by building a clear structure for risk management supported by a robust review process
  - **Strategy, tactics and operations** – to ensure scanning of the full range of risks facing the organisation
  - **Leadership and governance** – where the leaders of the organisation demonstrate commitment to risk management and set the right 'tone from the top'.

The enablers can, in combination, be used to support resilience. The ways in which the business enablers lead to increased resilience are context-specific as they depend on the size, nature and complexity of the organisation as well as its business environment and wider capabilities.

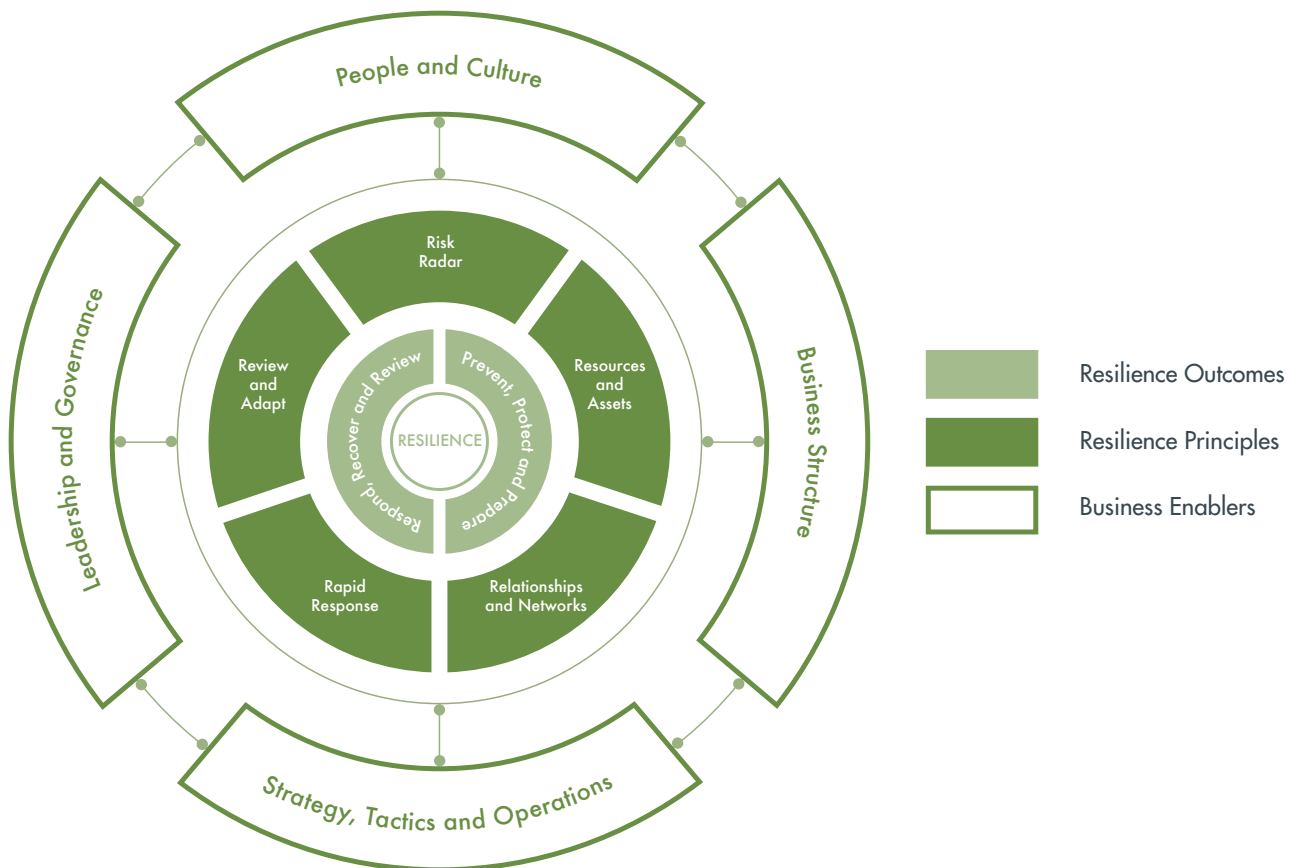
They also need to be applied all the way along the value chain, for example, a focus on the ‘people and culture’ would indicate the need to develop effective relationships and a shared sense of purpose with external business partners.

Similarly, in the light of the survey referred to above, Deloitte has identified four fundamental ‘resilience pillars’ of:

- **Visibility** – the ability to track what is going on along the value chain and take appropriate action
- **Flexibility** – the ability to adapt to disruptions
- **Collaboration** – the ability to develop trust-based relationships with value chain partners and other strategic networks
- **Control** – the ability to execute policies and processes that prevent disruptions.

These are consistent with the ‘5Rs’ identified in *Roads to Resilience*, although they do not explicitly mention the importance of reputation and the need to build a resilient culture.

FIGURE 2: Resilience outcomes, principles of resilience and the business enablers



Source: Roads to Resilience, Airmic, 2014

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The eight case studies show the importance of effective risk management and resilience building along the value chain. For example:

### **Jaguar Land Rover (JLR)**

When Jaguar Land Rover was taken over by Tata Motors in 2008, many of their suppliers decided to scale down production of parts for the company over concerns that the company would continue to struggle. When the reverse happened and sales picked up rapidly, JLR feared that growth could be constrained by a lack of supplier capacity. In response, specialist risk managers were appointed to work alongside the people who managed supplier risks as part of the day job. The two teams worked together to:

- Rationalise the supplier base and reduce dependency on small, low item suppliers
- Segment suppliers based on strategic importance and manage relationships accordingly
- Improve monitoring of capability and capacity of suppliers so that issues and solutions could be identified earlier.

### **The Olympic Delivery Authority (ODA)**

The ODA was established in 2006 as a public body responsible for the construction of venues and infrastructure for the 2012 Summer Olympic and Paralympic Games in London. This is an interesting example of an organisation with staff of fewer than 300, whilst having 1800 contractors to manage and a combined workforce peaking at 12,500. This meant a high priority was given to effective relationships and communication along the entire value chain with both suppliers and customers. It was observed by the Chief Risk Officer that ‘If you went on to the park and you had 30 people lined up in front of you, you couldn’t tell if they were ODA, CLM or a contractor, it was like a seamless team and everyone was committed to delivering this goal of the Olympic Park’.<sup>‡</sup>

### **Virgin Atlantic**

Virgin’s strong customer-focused and values-based approach to its business extends equally to its suppliers as a means of building resilience. For example, suppliers are treated as if they work for Virgin and where possible, even wear Virgin uniforms. ‘When you share the same values and work in partnership with your service providers, the approach to resolving a service delivery issue is much more collaborative, because it is also to their benefit to rectify the situation quickly’ (General Manager, Corporate Safety and Security).

While the three examples above have focused on aspects of risk in the supply chain, it is also important to note that strong focus on the customer and reputation was a particular feature of the companies studied, thus supporting effective risk management along the entire value chain. For example, the COO of Virgin Atlantic pointed out: ‘It is all about the customer and the experience’. Similarly at InterContinental Hotels Group (IHG), which operates seven brands including Holiday Inn and Crowne Plaza, reputation and the customer is never far from the thoughts of decision-makers. This is crucial for an organisation that has moved from being an asset-heavy, owner and operator of hotels to a largely franchised business; brand and reputation are now very important. ‘We know that reputation takes a lifetime to build but can be lost in a moment, so we mustn’t be complacent’ (SVP Head of Global Risk Management).

<sup>‡</sup> CLM was a consortium contracted by the ODA to act as programme managers.

# BUILDING RESILIENCE AND GOVERNING THE EXTENDED VALUE CHAIN

## 1. Mapping and understanding value chain risks

By its very nature, the extended value chain is likely to involve a range of partnerships and relationships. These can take a number of different forms, ranging from informal arrangements and one-off contracts to longer-term alliances and joint ventures.

It is therefore important to map and evaluate partnership risks and develop appropriate responses depending on the relative importance of the partnership or relationship, including the strengthening of due diligence and procurement policies, contracts, service level agreements and governance arrangements. For example, formal joint ventures will require strong governance structures, processes and culture.

A useful categorisation of the risks relating to such partnerships is:

- Performance risk
- Relational risk.<sup>15</sup>

Examples of each are shown in figure 3:<sup>16</sup>

With greater complexity and globalisation, cultural differences need particular attention to ensure that all participants have a shared understanding and agreed way of working. This applies to the extended value chain in that the company must understand cultural differences in its customer and investor base as well.

FIGURE 3: Partnership risks

Performance risk	Relational risk
Partner does not deliver product or service	Partner takes advantage of your intellectual property
Product/service does not meet required quality requirements	Misaligned incentives and profit-sharing
Unable to coordinate operations effectively, leading to missed objectives and targets	Cultural risks, for example, with cross-border partnerships – different views about ‘the rules of the game’
Planned joint innovation does not work	Compliance risks – what if your partners break the law?

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## 2. Using analytics and tools to build and manage resilience

Analytics and modelling tools can be invaluable in getting a better handle on the value chain. For example, the supply chain can be modelled with vulnerabilities identified at various points and organisations can quantify the impact of say, a supplier's facility being out of commission for a given period. Such models can be updated readily to reflect the changing nature of the supply chain.

Such models and analysis can also help organisations prioritise risk management activity to the most vulnerable parts of the supply chain. A recent study has shown that the most significant exposures can lie in unlikely places, for example, application of supply chain modelling techniques to companies such as Ford Motor Company showed little correlation between the annual spend on procurement at a specific site and the impact that the site's disruption would have on company performance. This meant that risks associated with low-cost, commodity suppliers were often overlooked.<sup>17</sup>

A similar example is that of Toyota which used analytics tools to map its supply chain and identify its most 'at risk' suppliers because, for example, they were a sole source of materials or in an area prone to earthquakes. Dependencies in the supply chain could also be identified.

The UK-based bank, RBS, is investing in data analytics and data warehousing in order to assess risk across its business customers' supply chains. It combines internal data generated from the transactions and payments processed by the bank with external information. The use of predictive analytics is enabling RBS to provide its corporate customers insight into supply chain risk, for example, by being able to map the interdependencies between companies.<sup>18</sup>

Such modelling techniques can also be applied to evaluate whether the supply chain is aligned with the organisation's values and therefore whether the organisation's brand and reputation is vulnerable. For example, one clothing retailer mapped its entire supply chain using Google Earth to visualise it from end to end. By overlaying key supplier risk data, it was able to gain a detailed understanding of its supply chain partners and their operations, to ensure that each component was aligned with its values. It was able to use this information to target supplier-management resources effectively.<sup>19</sup> There are also collaborative organisations for sharing data, for example, Sedex is a global platform for exchanging ethical supply chain data with over 30,000 members.<sup>20</sup>

## Governing the extended value chain

The key role of the board of the organisation is to 'facilitate effective, entrepreneurial and prudent management that can deliver the long-term success of the company' and 'to build sustainable businesses'.<sup>21</sup> In other words, the board needs to facilitate the creation of the conditions in which resilience can be achieved. It has particular responsibility for protecting and enhancing the **reputation** of the organisation. It also has primary responsibility for setting the right 'tone from the top' by articulating and modelling the desired ethical standards, behaviours, cultures and values of the organisation.

The five resilience principles above, supported by the four enablers provide a useful framework for boards to set the resilience agenda, but what are some of the specific challenges of governing the extended value chain? Boards should aim to address the following questions.

### Understanding the value chain

1. Do we have sufficient visibility and understanding of our value chain, particularly in terms of the key dependencies and the ethical aspects?

### Drivers of change

1. Do we understand how and why value chains are changing as well as the key drivers behind these changes?
2. Do we understand what the implications are for our strategy and business model?
3. What are other organisations doing, both in our own and other sectors? Can we learn from them?

### Crisis response

1. Are we satisfied that the organisation can respond effectively to disruptions and other crises along the value chain?

2. Are we learning lessons from other organisations' experiences?

### Governance and control

1. Are the governance and control arrangements and structures relating to our networks and value chain partners fit for purpose? For example: clarity over roles and responsibilities, monitoring and reporting, alignment of incentives and ethical standards/behaviours.
2. How often do we review this?
3. Is appropriate action being taken to address weaknesses?

### Partnerships and collaboration

1. Do we have a full appreciation of the importance of partnerships and collaborative relationships to the future resilience of the business?
2. Is the organisation developing competence in managing collaborative relationships?
3. Are there innovative ways of managing relationships?
4. How can the organisation ensure that this becomes a source of competitive advantage?

The CFO can influence this boardroom conversation by ensuring that the right questions are being asked and are supported by insightful, but focused information that helps the board understand the key issues, particularly through the lens of reputation. Given that investors are also taking an increasing interest in this area, the CFO must also ensure that external reporting meets investor requirements by providing assurance that boards are addressing risks in the extended value chain.

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# CONCLUSION

This briefing has touched on a wide range of issues, particularly relating to the ethical and risk aspects of the extended value chain and highlighted some of the key governance questions that boards need to address.

Every organisation will face different circumstances and challenges, for example, manufacturers and retailers will tend to have greater concerns over the sourcing and supply of resources while service-led businesses may need to focus more effort on aligning brand values, behaviours and incentives with their partners. However, what all organisations share in common is the need to have a transparent and thorough understanding of their value chains, viewed through the lens of reputation and resilience. Finance professionals have a key role to play in ensuring that organisations have the right information and are asking the right questions to support this effort.

## Further resources

This briefing is the first in a series exploring the extended value chain. To find out more, visit [cgma.org/valuechain](http://cgma.org/valuechain)

### **Ethical culture change at Siemens; a case study**

A CGMA case study which demonstrates the crucial importance of investing in the key resilience enablers.

**Combating corruption across the value chain**  
A CGMA and Transparency International (UK) briefing.

### **United Nations Global Compact Supply Chain resources**

The Global Compact's platform hosts resources on critical issues in supply chain management.

### **Sedex supply chain resources**

Resources from Sedex to help drive improvements in ethical and responsible business practices.



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