Volkswagen’s toxic mix of evolving and growing compliance risks (that should typically be caught in a robust enterprise risk management and compliance system) with the presence of strategic risks (that the board is responsible for overseeing) yielded what I would call the perfect reputation risk storm of 2015, or maybe even the decade.

Embedded in this crisis were several underlying and neglected compliance and strategic risks that explain why this scandal unravelled so quickly and had such a dramatic and immediate impact on stock price, car resale value, stakeholder value and more.

**The Volkswagen emissions scandal represents a classic example of reputation risk gone wrong and closes a turbulent year in reputation management.**

**Two compliance risks and three strategic risks**

It appears that Volkswagen had at least two serious underlying compliance risks:

- Product fraud, misrepresentation and false advertising (the defeat software)
- Environmental (toxic emissions many times higher than legally permitted)

Dr. Andrea Bonime-Blanc
Chief Executive Officer and Founder of GEC Risk Advisory
If Volkswagen had a robust enterprise risk management and compliance system, and had conducted rigorous analysis of the downside impact on its key stakeholders, perhaps the perfect risk storm would not have occurred. The stakeholder analysis (below) provides a quick overview of the multitude of stakeholders affected.

The two underlying compliance risks were either allowed to develop or were actively ignored. With the passage of time and addition of the following three strategic risks, it was only a matter of time before the perfect strategic risk storm would gather.

**Leadership risk** It appears from the facts we know that the leadership style of the previous CEO Martin Winterkorn was authoritarian, single-mindedly driven to create the number one auto company in the world, whatever it took, tolerating little or no dissent along the way. This could be a textbook case of leadership risk, something that we have learned from past cases (Enron, WorldCom, Lehman Brothers) can doom a company.

**Culture risk** Closely tied to leadership risk is culture risk. Why? The leadership style of a leader is often intimately linked to the performance, compensation, risk and reward structure of an organization. And the leader’s performance is in turn intimately connected to how the board treats that leader from a compensation and accountability standpoint. If all the board does is reward the CEO for financial metrics and not for how those metrics are achieved there is likely to be culture risk – a serious strategic risk.

**Reputation risk** Reputation risk as it relates to an organisation is almost always a strategic risk because of its very nature.

> "Reputation risk is an amplifier risk that layers on or attaches to other risks – especially Environmental Social and Governance (ESG) risks – adding negative or positive implications to the materiality, duration or expansion of the other risks on the affected organisation, person, product or service."

If one applies the reputation risk layer onto the underlying risks at Volkswagen the picture becomes clearer and more dramatic: the fact that the underlying environmental violation and product fraud risks were covered up or suppressed over a period of time (instead of addressed and repaired) explains why the reputation risk attached to these underlying risks grew over time.

In the case of the other two strategic risks – leadership and culture risk – reputation risk is tailor-made to amplify and worsen the impact of these risks: it has been claimed that leadership encouraged (tacitly or openly) risk-taking and rule-breaking, creating a culture where no one (employees and suppliers) felt safe to speak up about possible problems that might derail the overall strategy of the company – becoming the number one global auto company.

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**VOLKSWAGEN: EARLY STAKEHOLDER ANALYSIS**

- Customers - recall hassles, costs, embarrassment and anger of owning a less shiny brand that isn’t environmentally compliant
- Future customers - many will be lost to competitors
- Employees - dealing with investigations and embarrassment, many to lose jobs, others may vote with their feet
- Future employees - many lost to competitors or other industries
- The works councils - loss of prestige, power, ability to influence future outcomes
- The Town of Wolfsburg (Germany) - a company town, Wolfsburg and its economic eco-system have been built around Volkswagen
- The government of Lower Saxony - a Volkswagen shareholder and member of its supervisory board
- Dealers - recalls and embarrassed to carry the brand, likely to lose substantial future sales
- Audi, Seat, Skoda - the ‘brother’ auto companies under the Volkswagen umbrella may suffer collateral damage
- Other automakers - the microscope will be trained on other global automakers to find out whether similar deceitful practices abound
- Germany, the brand - much discussion is already underway on whether the stellar German brand for quality and engineering has been damaged
- Shareholders - already suffering devastating, probably unrecoverable equity losses, preparing for multiple types of law suits in multiple jurisdictions
- Banking and investment community - already burned, some may stay away, others may play financial games that may not benefit Volkswagen
- Environment - the diesel toxic emissions are 40 times greater than permitted under US law and arguably much worse for the health of living beings anywhere
- Executives and management (plus former executives and management) - under the gun and under the microscope of public opinion, governments, regulators and prosecutors for a long time to come
- The supervisory board - under pressure to ramp up more proactive corporate governance and/or engage in more wholesale corporate governance reform
- Multinational regulators - likely to ramp up investigations and be engaged in long-term investigations, prosecutions, settlements and compliance monitor arrangements
- Lawyers and consultants - arguably the only ones who will benefit greatly from this reputational catalysm
- The media and social media - will continue to have a party discussing every possible angle of this scandal, fanning the fires with information that may be accurate, inaccurate or downright malicious

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**The Volkswagen case: the role of the board**

The Volkswagen case is very recent and much remains to be known. But the severity and intensity of this scandal yields a number of important lessons even at this early stage. There are important reputation and strategic risk lessons, for the highest echelons of an entity – specifically the board.

As Volkswagen scrambles to deal with the immediate crisis by deploying its crisis management, there are a number of critical medium- to long-term activities that the company, its supervisory board and executive management must undertake to address their long-term survival and to restore the trust of its stakeholders including:

- Deep SWOT (strengths, weaknesses, opportunities, threats) analysis
- Corporate governance and culture overhaul
- Establishment of an effective global ethics and compliance programme
- Understand and deploy reputation risk within ERM
- Undertake stakeholder impact analysis and repair plan
- Build organisational resilience and long-term stakeholder trust

The rest of us must take advantage of this dark time to understand and repair the elements of organisational resilience that might be missing or under-deployed in our own organisations to build long-term resilience, trust and organisational strength for the longer term and to the benefit of our stakeholders. 