

## REPUTATIONAL RISKS IN THE CONSTRUCTION SECTOR IN TERMS DUE DILIGENCE

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**Abstract:** The article is devoted to the consideration of the features of assessing the business reputation of contractors in the construction industry. In modern conditions, the collection of information about the business reputation of a potential business partner is necessary to form an opinion about the degree of its reliability. The article summarizes the key factors and indicators for assessing the counterparty's business reputation in the context of the industry specifics of construction organizations. These factors and their indicators are designed to form a comprehensive view of the business reputation of the organization. For this purpose, a factor model is used and the value of the generalizing index is determined, its ranking is carried out. Depending on the obtained value of this index, a possible strategy for responding to the identified reputational risks when interacting with counterparties is determined.

**Keywords:** counterparty, business reputation, reputational risks, due diligence.

**JEL Classifications:** M49

### Introduction

When conducting business activities, there is a possibility of monetary losses due to the specifics of the internal and external business environment of the organization. The reason for such losses may be entrepreneurial risks, a special place in the structure of which is occupied by reputational risks [3, p. 167-168]. In this regard, further study of the nature of the occurrence of these risks in order to develop tactical and strategic decisions to minimize their impact on the activities of an economic entity is of particular relevance in modern conditions.

In general, the business reputation of an organization is a set of qualities and assessments with which their carrier is associated in the eyes of their counterparties, customers, consumers, work colleagues, voters and is personified among other professionals in this field of activity. Based on this definition, reputational risk can be defined as a real or potential threat to business reputation, which, if not properly controlled, can have a negative impact on it [3, p. 168-169].

To identify reputational risks, contractual due diligence becomes quite an effective tool, which can be provided as a service accompanying an audit and involves a comprehensive check of the counterparty before starting business cooperation for reliability.

### Main part

In order to identify reputational risks in the course of contractual due diligence that may arise when working with counterparties, it is necessary to understand the reasons for their occurrence.

The internal causes of reputational risk include:

- non-compliance by the counterparty with the requirements of the legislation of the Russian Federation, business practices, principles of professional ethics;
- failure to fulfill the obligations assumed under the contract;

- the lack of mechanisms in the internal control system aimed at regulating the conflict of interests of the client and the counterparty, as well as at reducing its negative consequences;
- the inability of the organization to effectively counteract the legalization (laundering) of proceeds from crime and the financing of terrorism, as well as other illegal activities carried out by dishonest clients and counterparties and (or) employees of the company;
- implementation by an economic entity of risky investment and market policies, a high level of operational risk, an ill-conceived personnel policy.

The external causes of reputational risk include:

- non-observance by affiliates of the organization, subsidiaries and dependent organizations, real owners of the company of the legislation of the Russian Federation, constituent and internal documents, business practices, principles of professional ethics;
- the inability of affiliates of the organization, as well as real owners, to effectively counteract the legalization (laundering) of proceeds from crime and the financing of terrorism;
- publication of negative information about the organization or its employees, shareholders, members of management bodies, affiliates, subsidiaries and affiliates in the media.

The economic literature presents various approaches to the assessment of reputational risks, which should be taken into account in the course of their diagnosis during due diligence. The following classification of reputational risks is proposed:

1. Corporate risks are caused by problems associated with the activities of the organization (production, management, etc.).
2. Global risks are caused by factors that are not typical for one organization, but for a number of enterprises in the same industry (environmental problems, worsening economic conditions, etc.).
3. Local risks do not occur in relation to the entire organization, but to its individual employees and employees (mass layoffs).

With regard to assessing the reliability of counterparties in the course of contractual due diligence, reputational risk occurs when a counterparty can be characterized as a person with a negative business reputation due to the fact that they repeatedly failed to deliver goods, perform work or provide services. Besides, additional factors indicating the presence of a risk of this type may be the repeated participation of the counterparty in court proceedings as a defendant [4, p.109].

In order to identify reputational risks in the course of contractual due diligence, information is collected that can characterize business reputation from a negative side. In this case, information from publicly available sources, the media, specialized databases, and online services are used as an information base.

You can set key indicators for assessing the business reputation of a counterparty by highlighting the most significant factors that characterize the organization. The following can be said about the state and level of development of an economic entity:

- history of the company;
- the presence of a quality control system (does not guarantee, but testifies in favor of the high quality of the products and services offered);
- conscientious fulfillment of contractual obligations (no claims to the timing of deliveries, timeliness of payments);
- reputation as a partner among other firms, credit history;
- the popularity of products and the company as a whole - it will help to assess which sector the counterparty occupies in the market, how high the demand for its products is, etc.;
- financial condition (solvency of the organization).

Table 1 summarizes the factors and key indicators used to assess the business reputation of a counterparty in the course of contractual due diligence.

**Table 1.** Key factors and indicators for assessing the business reputation of the counterparty

№	Estimated factor	Indicator
1	Organization history	Number of years in the market of goods and services
2	Quality of products and services	Product quality level, Availability of a quality management system
3	Conscientiousness of the obligations assumed by the counterparty	The share of contracts terminated due to non-fulfillment of their obligations
4	Reputation of the counterparty as a partner (partners)	Quality of interaction with other companies
5	Reputation of a law-abiding counterparty	Availability of arbitration cases (lawsuits, applications, complaints from counterparties)
6	The financial condition of the organization	Return on sales Average maturity of receivables (accounts payable) Financial autonomy ratio
7	Fame of the product and the organization as a whole	The level of awareness of the organization and the services provided
8	Organization credit history	Absence of violated terms of the company's loan agreements with financial institutions
9	Reliability of information	The level of reliability of the information provided

*Source:* Compiled from [2].

When carrying out the verification of counterparties, the organization should take into account industry specifics. When studying counterparties of a construction organization when checking their business reputation in the course of diagnosing the occurrence of reputational risks, attention is paid to the following factors and indicators characterizing them, presented in Table 2.

**Table 2.** Factors and indicators for the analysis of the business reputation of a construction organization

№	Estimated factor	Indicators
1	Organization history	Indicator 1.1: Number of years in the market characterizes the number of years the organization has been in the construction market Indicator 1.2: Rhythm of work, determines the rhythm of work performance, characterized by the coefficient of variation of the volume of construction and installation works of the organization
2	Fixed assets Current assets	Indicator 2.1: Material and technical base, takes into account the availability of construction machinery and equipment in value terms, both owned by the organization and leased Indicator 2.2: Financial autonomy characterizes the financial independence of a construction organization, determined by the ratio of equity to borrowed funds Indicator 2.3: Construction in progress characterizes the ratio of construction in progress to profit
3	Personnel	Indicator 3.1: Management personnel, characterizes the level of education, work experience in the organization and practical experience in the field of building top managers (heads of the organization)

		<p>Indicator 3.2: Middle link, characterizes the level of special education, work experience in the organization of specialists</p> <p>Indicator 3.3: Awards and titles, takes into account the presence of employees with academic degrees and (or) honorary titles</p>
4	Image	<p>Indicator 4.1: Citation refers to how often the organization has been cited in print, electronic media and other media</p> <p>Indicator 4.2: Elimination of violations, characterizes judicial practice organizations</p> <p>Indicator 4.3: Delay in delivery of objects, takes into account the average duration of delays in the delivery of construction objects</p> <p>Indicator 4.4: Emergencies, characterizes the level of labor protection at the organization's facilities</p> <p>Indicator 4.5: Certified management system, characterizes the availability of certificates for the management system issued by a body accredited by the Federal Accreditation Service (Rosakkreditatsiya)</p> <p>Indicator 4.6: Feedback from customers, takes into account the presence of favorable feedback and thanks from customers</p>

*Source:* compiled according to [1].

To obtain information, the following documents of the organization are subject to verification:

1. Constituent documents: certificate of state registration of a legal entity or individual entrepreneur, certificate of tax registration, decision to establish a legal entity, the charter of the organization and all subsequent changes to the charter, orders on the appointment of the heads of the organization for the entire period of the organization's operation, an extract from Unified State Register of Legal Entities.
2. Certificates of admission to certain types of work from a self-regulatory organization.
3. Certificates of conformity of the quality management system, environmental management, labor protection management, other licenses and documents confirming the right of the organization to carry out construction activities.
4. Staffing tables of the organization for the entire period of the organization's activity and orders for their approval and change.
5. Certificate «Heads of the organization» indicating the length of service in the organization and in the construction industry of all heads of the organization.
6. Diplomas (copies), workbooks, employment orders, employment contracts for each manager, according to the organization's staffing table. Documents on the passage of advanced training.
7. Reference «Labor resources» indicating the length of service in the organization of all employees, according to the staffing table.
8. Diplomas (copies), workbooks, employment orders, employment contracts for craftsmen, installers, foremen, specialists according to the staffing table. Documents on the passage of advanced training.
9. Diplomas on conferring the titles of candidates and doctors of science (if any).
10. Documents on awarding the title «Honorary Builder of Russia», «Honorary Builder of the RSFSR» or their equivalents (if any).
11. Standard employment contract for each employee, according to the staffing table. If a collective labor contract is concluded - a collective labor contract.
12. Register of completed work contracts for the entire period under review of the organization's activity.
13. Agreements to the registry and closing documents (acts of work performed).

14. Certificate of publications in the media (media) about the organization with a list of references in the media and sources.

15. Certificate of availability of court decisions that have entered into force, according to which the organization acted as a defendant.

16. Certificate of emergencies that occurred at the facilities of a construction organization.

17. Reviews of customers of construction works.

18. Photographs of the material and technical base.

19. Balance for each year of the audited period.

20. Statement of financial results for each year.

21. Income tax return for each year.

22. VAT declaration for each quarter of the entire period under review.

23. Turnover balance sheet for all accounts (general) as of December 31 of each year.

24. Turnover balance sheet for account 01 «Fixed assets» as of December 31 of each year.

25. Analysis of account 68.2 by corresponding sub-accounts for each quarter of all years (for each VAT declaration).

26. An extract from the book of purchases and sales with a total line for each quarter of the entire period under review.

27. Statement of current account balances as of December 31 of each year of the entire period under review.

28. Notification of registration at the location of separate subdivisions or real estate.

29. Decisions on the payment of dividends (if any).

30. Certificate of actually carried out activities with OKVED codes. The period under consideration is three calendar years preceding the moment of assessment.

31. Other documents requested by experts conducting contractual due diligence [1].

These indicators form a factorial model that looks like:

$$R_f = (x_1d_1 + x_2d_2 + x_3d_3 + x_4d_4)*z; \quad (1)$$

Where  $d_1, \dots, d_n$  are the weighting factors of the factors, determined by an expert in such a way that in the ideal case  $R_f = 100$ , i.e. at  $x_1 = x_2 = x_3 = x_4 = 100$  and  $d_1 + d_2 + d_3 + d_4 = 1$ ,  $z = 1$ ;

$x_1$  - the «History» factor characterizes the duration of the organization's presence in the market and the amount of work performed by it;

$x_2$  - factor «Fixed assets, Current assets», depends on the provision of the organization with the resources necessary for construction work;

$x_3$  - factor «Personnel», characterizes the presence of qualified specialists and managers in the organization;

$x_4$  – «Image» factor characterizes the perception of the organization by customers and society as a whole;

$z$  - coefficient «Reliability», characterizes the completeness and reliability of the information provided by the organization.

In turn, the factors  $x_1 - x_4$  are determined through indicators (column 3 of table 2), which can be calculated using the information provided by the assessed organization, and the data for calculating the coefficient  $z$  is issued by a third party. To calculate each indicator, a separate algorithm is provided using the appropriate ranking scale for the results obtained [1].

### Conclusion

Thus, the formation of a factor model makes it possible to assess the likelihood of reputational risks arising when interacting with an organization. The experts conducting the verification themselves can establish the ranking of the obtained index value  $R_f$ . As a possible option, the following gradation of the results obtained can be proposed:

1) Acceptable risk:  $R_f$  - from 90 to 100.

2) Average risk:  $R_f$  - from 70 to 89.

3) High risk  $R_a$  - from 50 to 69.

4) Catastrophic - Rf - from 0 to 49.

As you know, the following methods are used in risk management:

1. Risk avoidance - is a conscious decision not to be exposed to a certain type of risk.
2. Damage prevention (risk mitigation) - this technique includes actions taken to reduce the likelihood of losses and to minimize their consequences.
3. Acceptance of risk - is to cover losses at the expense of available resources.
4. Risk transfer - is the transfer of risk to other persons.
5. Risk diversification - consists in the distribution of financial resources between different investment objects so that in the event of negative consequences of risk in one branch of activity, the rest do not suffer [5, p. 87-91].

When interpreting the value of the Rf index as an acceptable level of risk, it is possible to apply a risk-taking strategy, and in this case, in the case of starting cooperation with a counterparty, it is recommended to work on an advance payment and constantly monitor information about the counterparty. When identifying a medium level of risk, a risk-taking strategy is also appropriate, as well as loss prevention strategies and risk transfer. In this case, it would also be a reasonable solution to use a prepaid settlement system, letters of credit, insurance contracts, and the creation of reserves for doubtful debts. In the case of a high probability of reputational risks, risk avoidance strategies, risk transfer, risk diversification are recommended. Risk avoidance involves refusing to work with the specified counterparty, risk transfer is also implemented through insurance contracts, and risk diversification in this case involves refusing to work with only one counterparty, searching for new business partners. With a catastrophic risk, only the risk avoidance method is possible, and it is not recommended to start business cooperation with this counterparty.

The undoubted advantage of this factor model is the use of a significant number of indicators for a more accurate assessment. At the same time, as weak points of this model, one can note a certain subjectivity when using expert opinion and sufficient labor intensity.

Thus, the reputational risk management process assumes that various methods will be used that will allow to some extent predict the onset of a particular risk event, as well as take targeted actions to reduce the degree of risk. It is almost impossible to avoid risk in entrepreneurial activity, but knowing the source of risks, the entrepreneur is able to reduce their level by reducing the impact of adverse factors.

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