

# Value judgment

*Irvin Varkonyi asks whether a company's decision to introduce better cargo security measures can enhance its reputation with investors*



Irvin Varkonyi is Director of Education for the Trade Security Institute. He has spoken at some of the leading organisations in transportation and supply chain security including the American Society for Industrial Security (ASIS), Air Cargo Americas, Technology Asset Protection Association (TAPA), the National Cargo Security Council (NCSC), Transportation Lawyers Association and the National Defense Transportation Association. Irvin wrote about the 'human factor' in the supply chain in the August issue of *Cargo Security International*.

What is the value for investors to be better informed about the level of security within companies when they decide on potential investments in their current portfolio? How does the average Wall Street analyst view preparedness in the supply chain as a factor to evaluate stock value? Is this important for investors?

Obviously, investors take risk into account but generally the perception of risk is limited to the chances that their investment will appreciate. What are the factors to consider when investors consider supply chain management risk?

## Six key questions

- Are there incentives for corporations to become more secure?
- Does Wall Street understand uncertainty in the supply chain?
- Who understands risk management in the supply chain?
- How does the consumer value security?
- Does the imposition of government regulations level the playing field for competitors?
- How does the insurance industry value cargo security?

## Corporate incentives

The for-profit enterprise requires incentives for expenditures with a positive return on investment. Expenditure of costs must yield an appropriate return based on the organisation's standards. What are the incentives for corporations to be secure? While the question is logical, the assumptions about security change the meaning of incentives. If the organisation assumes that there is insufficient risk to expend substantial funds for countermeasures, then it is likely that it will see little reason to spend those funds. If expenditures on countermeasures negatively affect shareholder value, then action is likely not to be taken. If Wall Street analysts determine that corporate expenditures on countermeasures will not offer an appropriate return, does the enterprise then have a disincentive to take those countermeasures?

It is obvious that corporations want to be

secure, because increased uncertainty leads to increased costs. The supply chain is subject to risk in the movement of cargo amongst the supply chain partners.

## Wall Street understanding

Uncertainty comes from many different areas. How well trained are global company personnel in protecting the firm? Do personnel turnover frequently, causing discontinuity (see *Cargo Security International*, August, page 42)? How much does increased outsourcing, through adding production and supply nodes to global networks, add to uncertainty? Such globalisation creates complexity, introducing delays and volatility. Does Wall Street evaluate an organisation's capability to anticipate disruption and mitigate against its consequences? In simplest terms, is there value in how securely the enterprise moves cargo from origin to the final point of sale?

The factors which influence Wall Street traders' evaluations tend to minimize the level of security in the enterprise because the metrics are not clear. In a recent study entitled *An empirical model of stock analysts' recommendations: market fundamentals, conflicts of interest and peer effects*, Patrick Bajari and John Krainer ascribed a great deal of influence by peers among peers, leading to a 'follow the crowd' mentality. Does this crowd understand supply chain vulnerability and cargo protection?

What about cargo theft? Does it have a strong influence on the corporation's value either? Essentially, it is hidden inside the cost of goods. What about the level of insurance payments received by companies to reimburse their losses? Should there be a standard benchmark for the return on investment (ROI) on measures to be taken to make the enterprise more secure? The dollars spent on countermeasures are not subjected to rigorous analysis of their ROI, as corporations tend to dismiss the value of this type of analysis.

The **First Advantage Corporation** has produced such ROI data and has been working diligently to spread the word in the industry (see *Cargo Security International*, April, page 17).

Let's return to uncertainty. The increased complexity of supply chains caused by outsourcing has increased the number of hand-offs or touch points within the supply chain. Preliminary results from the **US Department of Homeland Security's (DHS) Operation Safe Commerce** indicate that there are twice as many touch points in an average supply chain than was previously believed. Does this not mean twice as many potential points of disruption via theft, terrorism or other factors? Shouldn't Wall Street evaluate the ability of the enterprise to manage the increased amount of touch points?

### Risk management

**Montgomery Research** analyst, Andre Kuper, stated in *Risk Management in the Supply Chain* (Accenture Consulting, Summer 2004): 'Measuring the impact of risk management is one thing, aligning the metrics of the people involved with the desired behavior requires additional investment and changes to the culture and division of labor.'

'If managers invest to reduce risk, and the disruption never takes place, they should not be displaced, just as the individual car owner should keep their insurance even when an accident never takes place.'

'Acknowledgment of successful risk management activities by individuals is a critical success factor.'

Change is ongoing in the global environment and it requires ongoing organisational efforts to mitigate against potential disruptions.

### Consumers' perceptions

What about the perception by the consumer of the value of security? Does the public think about it? In many cases, they do. Going into a bank, we clearly think about it - yet we expect all banks to have the same level of security.

There are no public statistics on this, but perhaps Wall Street analysts should utilise the level of safety to the public as a determinant in evaluating the stock.

In a conference at **George Mason University (GMU)** in October 2004, a group of citizens was brought together with experts on critical infrastructure. The discussions were wide ranging with the citizens questioning the safety of utility companies, transportation providers and others. This group put a value on security, but do the public accept the need to pay the price of security?

### Government regulations

Government regulations are viewed as added cost to doing business. Does the Sarbanes Oxley Act (SOX) add to costs? SOX compels publicly traded organisations to accept the obligation to manage their financial transactions or risk penalties on individual managers and the enterprise. Many think SOX adds costs because of the need to bring in consultants and add staff to process SOX documentation. But there are benefits too: the risk of financial disruption is reduced, including eliminating vendors who are unable to provide satisfactory protection in the movement of cargo? Does Wall Street value a company fully applying itself in this effort (thereby spending more cash) if this reduces the risk of disruption by discarding unsecured vendors?

A question was posed at the GMU conference - how do we pay for extra security? Do we:

- impose regulations on all businesses to level the playing field, thus removing security as a competitive advantage (or disadvantage?)
- have the federal government directly pay for additional expenses needed for protection of the enterprise, including the movement of cargo via multi-modal transportation?
- make security a user-fee based process, to show the public the costs of security?

I will leave it to the reader to evaluate these three options.

### Insurance industry

Insurance covers the losses of the enterprise, from individual theft to organised theft; theft

in the warehouse to theft in transit. So what about adding additional pro-active measures to reduce theft, as well as reduce the chances of disruption from terrorism? In the US, President Bill Clinton's administration made a strong effort to move the insurance industry toward recognising the efforts of the private sector to protect itself from disruption. The US was indeed looking at efforts to protect itself against terrorism before 9/11.

But what was the reaction of the insurance industry? It was deemed that the Clinton effort was speculative and not profit-oriented, according to Michael Armstrong, former deputy director of the **Federal Emergency Management Agency**. Industry objections to being forced to insure customers against geo-political forces carried much weight. Efforts at mitigation by industry were not as important as the actual decrease in claims. Of course, if you have not had a claim against losses incurred by terrorism, you have no incentive to develop countermeasures, at least not to reduce your insurance premiums.

The current US federal commitment to co-insure companies against terrorism will shortly terminate as the three year Terrorism act will soon expire, if it is not renewed by the Congress. It was hoped that the private sector would be able to figure out how to commercially insure against terrorism, but it has not.

While there is no federal programme to help Wall Street analysts figure out how to value preparedness, it is apparent that Wall Street has not figured this out either. If this is so, then who will protect the shareholders?

#### Contact:

Irvin S. Varkonyi  
 Director of Education  
 Trade Security Institute  
 Tel: +1 703 863 9686  
 Fax: +1 703 503 5685  
 Email:  
[ivarkonyi@tradesecinstitute.com](mailto:ivarkonyi@tradesecinstitute.com)  
 Web: [www.tradesecinstitute.com](http://www.tradesecinstitute.com)