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Linking corporate reputation and shareholder value using the publication of reputation rankings

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ABSTRACT

Good corporate reputation is one of the most valuable assets and causes a multitude of favorable impacts within different stakeholder groups. As a consequence, a lot of studies analyze the relationship between corporate reputation and financial performance. However, most of them raise the question of causation due to their methodology. In order to isolate the causal impact of corporate reputation on financial performance, some authors conduct event studies, but without remarkable success. Therefore, this study provides initially a comprehensive theoretical background for why reputation should affect financial performance. According to the resulting hypotheses, an event study is conducted to analyze the impact of the publication of reputation rankings by the German *Manager Magazin* on share prices. As hypothesized, positive and negative announcement effects exist regarding upgraded or downgraded companies respectively. Consequently, investors gain new information from the published rankings (increases or decreases in reputation) to adjust share prices.

1. Introduction

The major change in management research during the last decades has been the paradigmatic move from thinking in tangible to intangible assets (Barney, 1991). This movement is attributable to the assumption that intangibles are the major drivers of sustainable performance due to their characteristics. Competitors cannot easily neutralize these assets because they are hard to copy and in general not tradable via factor markets. As one of these intangibles, corporate reputation has become one of the most discussed (Abimbola & Vallaster, 2007; Caruana, 1997; Hunt & Morgan, 1995) and most valuable assets (Hall, 1992), because reputation is considerably able to defend a competitive position (Dierickx & Cool, 1989; Jones, Jones, & Little, 2000) especially by buffering negative critical incidents (Dhir & Vinen, 2005). As a consequence, the assumption arises that a consistent and strong relationship between company reputation and financial performance exists. That implies that a relationship should also exist between information contained in corporate reputation rankings and financial performance.

A number of research studies analyze this relationship (e.g., Dunbar & Schwalbach, 2000; Inglis, Morley, & Sammut, 2006; Rose & Thomsen, 2004; Sánchez & Satorrío, 2007), but none of them confirms, beyond any doubt, an influence of corporate reputation on financial performance. Analyses either cannot prove the claimed effects or the direction of causation is not clear (McGuire, Schneeweis, & Branch, 1990; McGuire, Sundgren, & Schneeweis, 1988).

In order to isolate the effect of reputation on financial performance, Hannon and Milkovich (1996), Ittner and Larcker (1998), Fornell, Mithas, Morgeson, and Krishnan (2006) as well as Abraham, Friedman, Khan, and Skolnik (2008) look for announcement effects of publishing reputation data. However, these studies are unable to confirm an impact on shareholder value.

Therefore, this event study is conducted using a refined methodology and different data (reputation rankings). More concretely, this study investigates whether announcing significant positive (negative) changes of corporate reputation measures affect shareholder value in the same direction. In contrast to previous ones, this study confirms a relationship as expected.

The paper starts with theoretical bases of corporate reputation and shareholder value as well as their interdependencies. This passage includes an overview of general drivers derived from financial and management theory, followed by a closer look at the specific (possible) impact of good reputation on shareholder value. After that, a discussion of the information contained in published reputation rankings under the assumption of market efficiency follows. The next two sections describe the methodological approach and the used sample. Finally, the paper moves on to the presentation and discussion of the results.

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2. Theoretical basis

2.1. The concept of corporate reputation

As a result of interdisciplinary initiated and driven research on corporate reputation and different perspectives ranging from psychological to managerial, a host of different concepts of reputation exist. To date, experts broadly accept that reputation is a collective construct which reflects an aggregated view of individual perceptions (Barnett, Jermier, & Lafferty, 2006; Walker, 2010; Wartick, 1992).

Additionally, a general agreement exists that corporate reputation measurements have to focus on the relevant stakeholders (Boulstridge & Carrigan, 2000). Concerning measurement approaches, a distinction is possible between taking an overall perspective (Fombrun, 1996), including internal and external stakeholders; a stakeholder group-specific perspective (Bromley, 2002a); an issue-specific perspective, within different groups of stakeholders; and an overall issue-specific perspective (Walker, 2010). The question is not whether perceived differences exist between multiple stakeholder groups as shown in Fig. 1 but rather to which extent.

The relational school (Chun, 2005) addresses this question by comparing multiple stakeholder views. Based on information asymmetry between internal (insiders) and external stakeholders (outsiders), the perceptional gap between them is most evident. Considering even the smallest differences between the groups within insiders and outsiders, the authors define corporate reputation as:

A relatively stable, aggregated and indirectly suggestible perception within multiple stakeholder groups based on a company's past actions and future prospects in comparison to some reference.

In contrast to Walker's (2010) perspective, the exclusion of the issue-specific term is crucial because of the assumption that corporate reputation represents a simplified collective assessment. Findings on the existence of halo-effects support this assumption (Brown & Perry, 1994; Schultz, Mouritsen, & Gabrielsen, 2001). However, this definition does not mean that an overall aggregation, as Fombrun (1996) states, is not acceptable. It emphasizes the allowance of and not the need for variety in general. Indeed, the absence of such a variety is due to a potential contamination of a favorable reputation by an unfavorable one or vice versa (Carter & Deephouse, 1999). Furthermore, the empirical findings of Eberl and Schwaiger (2005) support the idea that corporate reputation between various stakeholder groups is comparable. In line with these theoretical approaches and empirical findings, corporate reputation within one stakeholder group is an indicator for others in general.

2.2. Shareholder value

According to Rappaport (1998), shareholder value is the difference between the corporate value and its debts. The corporate value reflects the present value of cash flows (*CF*) generated by the firm's operations during the forecast period and the residual value (*R*) afterwards. Both cash flows and the residual value are uncertain expectations. The estimations of them take into account different states, cash flows and their related probabilities. An often proposed risk adjusted discount rate (r) of these expectations is the weighted-average cost of capital (WACC) regarding a target capital structure (Rappaport, 1998). Thus, the definition of shareholder value (*SV*) is:

$$SV = \frac{CF_1}{(1+r)} + \frac{CF_2}{(1+r)^2} + \cdots + \frac{CF_\tau}{(1+r)^\tau} + \frac{R}{r(1+r)^\tau} - Debt. \quad (1)$$

By dividing this amount (*SV*) by the total number of issued shares, the price per share results. Using this model, financial decisions such as share repurchase programs (Grullon & Michaely, 2004; Stephens & Weisbach, 1998), issues of new shares (Barclay & Litzenberger, 1988) or changes in the capital structure affect share prices (Masulis, 1980, 1983). Hence, after checking and excluding such price-changing causes during the observation period, three potential drivers of shareholder value remain.

First, the cash flows (*CF*) can be both enhanced and accelerated as illustrated in Fig. 2. Accelerating cash flows increases the present value as a result of being less discounted, which is attributable to time and risk adjustments. Second, changes of the discount rate (r) have an impact. Given that this interest rate has to compensate risks borne by debt holders and shareholders, a risk reduction minimizes capital costs ($1 + r$). Consequently, the present value shifts in favor of shareholders. In addition to accelerating cash flows, a risk reduction may be achieved by declining volatility and vulnerability of cash flows. The third remaining opportunity is to enhance the residual value (*R*).

However, all drivers have in common that they are, solely or in sum, just sufficient conditions for affecting shareholder value. The necessary

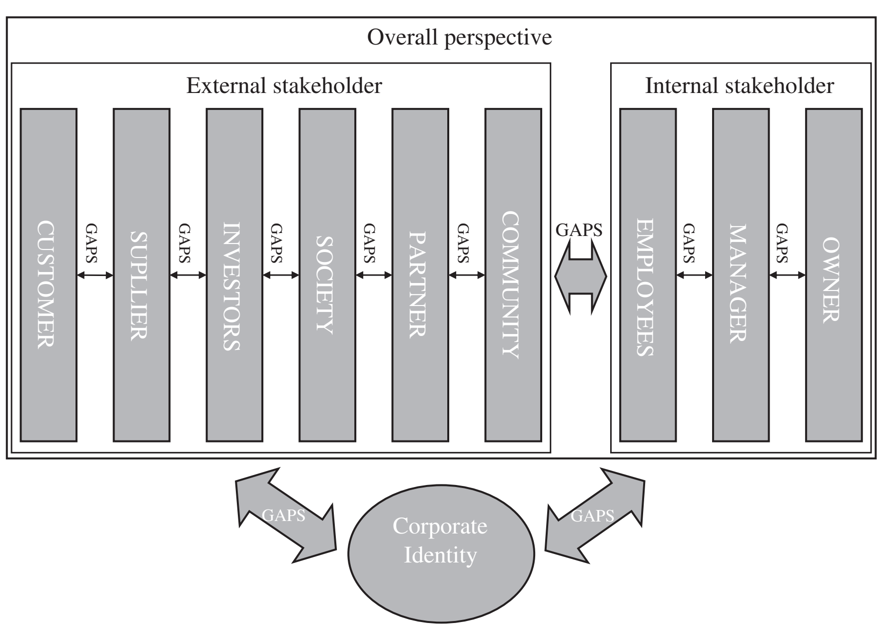

Fig. 1. Key elements of corporate reputation and the corresponding information gaps (following Chun, 2005).