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The impact of corporate reputation and reputation damaging events on financial performance: Empirical evidence from the literature

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ABSTRACT

Corporate reputation and reputation risk are becoming increasingly relevant for firms, also caused by its relevance for firm value. In this context, this paper provides a comprehensive survey of empirical evidence in the literature regarding the relation between reputation damaging events, corporate reputation, and corporate financial performance, thereby also taking into account stakeholder behavior. The review is also intended to determine to what extent the current literature allows a holistic understanding of these relationships in the sense of the causal chain of events, which is of high relevance when managing reputation and reputation risk. Thus, focus is first laid on empirical evidence regarding the impact of corporate reputation on stakeholder behavior and on financial performance. Next, the event study literature regarding the effect of reputation damaging events on corporate reputation and financial performance is reviewed, and, finally, implications for risk management are discussed along with the need for future research.

1. Introduction

The protection of a company's reputation is one of the most relevant and difficult tasks for a risk manager. The BP oil spill in the Gulf of Mexico and Toyota's recall of vehicles due to defect concerns are only two examples that show how easy a good reputation can be damaged. In addition, reputation risk is becoming increasingly important for firms especially against the background of the increasing prominence of social media and the internet (Lee, Hutton, & Shu, 2015; Scott & Walsham, 2005), where particularly bad news spread faster. For companies, one main question is thereby whether the level of corporate reputation or reputation damaging events (also referred to as “crisis events”) actually has an impact on corporate financial performance, e.g. due to a reduction in revenue caused by an adverse change in stakeholder behavior (e.g. higher costs of capital, less motivated employees).[1] Relevant internal and external stakeholder groups typically include customers, suppliers, (potential) employees, investors, and local communities (e.g. Fombrun & van Riel, 1997; Tischer & Hildebrandt, 2014).[2] Reputations can differ among stakeholder groups as a firm can have, e.g., a good reputation among investors but a bad one as an employer (see, e.g., Ali, Lynch, Melewar, & Jin, 2015; Walker, 2010). These considerations also play a major role for the success of crisis communication, where multi-stakeholder strategies are typically applied after a reputational crisis event (see Chakravarthy, deHaan, & Rajgopal, 2014). Risk management thus requires an in-depth understanding of these relationships and interactions between corporate reputation, reputation damaging events and financial consequences, thereby also taking into account the perspective and behavior of a firm's stakeholders. Against this background, the aim of this paper is to gain a better understanding of effective risk management through a comprehensive presentation of empirical evidence regarding these four relationships,

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[1] For instance, in the context of accounting scandals as the relevant reputation damaging event, Chakravarthy et al. (2014) define reputation-related market losses “due to increased uncertainty and diminished expectations among stakeholders about the firm's intent and ability to uphold its commitments. Specifically, reputation capital is devalued due to: (1) expected increases in financing costs imposed by capital providers; (2) expected increases in the costs of transacting with a firm's other stakeholders, including customers, employees, and the geographic communities in which the firm operates; and (3) expected decreases in future cash flows from sources such as lost sales, abandoned projects, and increased litigation,” (p. 1330), thereby also referring to Murphy et al. (2009) and Karpoff et al. (2008), among others.

[2] Chun (2005) identifies different schools of thought in the literature (evaluative, impressional, relational) which exhibit main differences in regard to “which stakeholders are taken as the focal point, rather than their subject area or epistemological base” (p. 93).

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which is done based on a systematic literature review. In the analysis, focus is also laid on whether the causation (e.g. stakeholder behavior) is taken into account in the empirical studies to determine to what extent the current literature allows a holistic understanding of the cause and effect of reputation risk in the sense of understanding the causal chain of events. The review is thus not only intended to present the current state of the literature, but also to gain valuable insight into relationships that are of high relevance for risk management and to point out potential future fields of research.

The literature offers a variety of definitions and measurement approaches of corporate reputation with overviews provided in, e.g., Barnett, Jermier, and Lafferty (2006), Clardy (2012), Lange, Lee, and Dai (2011), and Walker (2010). General consensus appears to exist in that reputation is multidimensional, reflecting the aggregate perceptions of a firm's stakeholders on financial and non-financial aspects (Fombrun, 1996; Rindova, Williamson, Petkova, & Sever, 2005, 2010), and that it allows potentially significant competitive advantage for firms with higher reputation (Fombrun & Shanley, 1990). Finally, reputation is also considered a strategic intangible asset (Hall, 1992).[3] While there have been several surveys of the empirical literature on corporate reputation and reputation risk, they mostly focus on one relationship only, e.g. either the relation between reputation damaging events and financial performance or between corporate reputation and financial effects. De la Fuente Sabate and de Quevedo Puente (2003), for instance, conduct a survey of the early empirical literature on the relation between corporate reputation and financial performance, while Walter (2013) provides a short overview of the impact of reputation damaging events on financial performance with focus on reputation risk. Furthermore, Ali et al. (2015) conduct a meta-analytical review of 101 quantitative studies with focus on the moderating roles of three factors, including stakeholder group, country of study, and reputational measure, which are of relevance for the relation between antecedents of reputation (e.g. financial performance, firm size, firm age, media visibility, corporate social performance, long-term institutional ownership) and its consequences (financial performance, customer trust, customer loyalty, customer commitment). Their quantitative comparison shows that the relation between corporate reputation and its antecedents and consequences depends on the country of the study as well as the reputation measure. In addition, the type of stakeholder group (“top management and analysts”, “all others”) implies significant differences in the association of corporate reputation with all considered antecedents except for media visibility. Furthermore, the stakeholder group is a significant moderator for the size of the effect of reputation on financial performance.

The aim of this paper is contribute to the literature by taking a different perspective in that explicit focus is laid on empirical evidence regarding four major relationships. This presentation is not only intended to present the current state of knowledge, but it is also intended to provide important insight for reputation risk management (i.e. for identifying, assessing, responding, and monitoring reputation risk), which requires a comprehensive consideration and understanding of these relationships and what is known from the empirical literature to assess and manage reputation risk (in the sense of financial losses for a firm due to stakeholder behavior, for instance, caused by a generally lower level of reputation or a reputation damaging event). While empirical evidence may not always be generalizable, it still provides important insight whether certain reputation damaging events may severely impact financial performance, for instance. In particular, even though few insurance solutions have recently become available to mitigate the effects of reputation damaging events by providing loss control and partial coverage of financial losses as studied in Gatzert, Schmit, and Kolb (2014), pre-event prevention and an adequate (reputation) risk management including crisis communication strategies are vital to proactively manage reputation risk (see Eccles, Newquist, & Schatz, 2007), where considerations regarding these four relationships play a major role.

The paper is structured as follows. Section 2 presents the methodology of the literature review as well as an overview of the results, which are then discussed in detail in the following sections. In particular, Section 3 focuses on the empirically observed impact of corporate reputation on stakeholder behavior and on corporate financial performance. In Section 4, focus is laid on the event study literature, and Section 5 summarizes the results and provides an outlook with focus on risk management aspects.

2. Methodology and analysis

2.1. Literature review – methodology and analysis

As described previously, focus is laid on empirical research regarding the following four relationships:

- The impact of corporate reputation
  - on stakeholder behavior (Section 3.1) and
  - on corporate financial performance (Section 3.2)
- The impact of reputation damaging (risk) events
  - on corporate reputation (Section 4.1) and
  - on corporate financial performance (Section 4.2).

To identify the current state of knowledge regarding empirical evidence in the academic literature, a systematic literature review was conducted. Toward this end, the *Web of Science* database was used as one of the largest databases, which includes a large range of disciplines (see also Walker, 2010, p. 359). All articles in journals with an impact factor greater or equal than 1 were included in the analysis as is done in Lange et al. (2011), whereby impact factors were extracted from the *ISI Web of Knowledge* database and matched with the journals of the *Web of Science* database using their ISSN number. The time span was chosen from 1990 to 2015, as reputation research grew rapidly in the 1990s (see Walker, 2010, p. 360).

Two searches were conducted using keywords in the topic of the article (includes title, keywords, and abstract). The first search included the keywords “corporate reputation” and “firm value”/“market reaction”/“performance”, “reputational risk”, “reputation risk”, reputational loss”, “reputational penalty”, “reputational penalties”, or “reputational damage.” To refine the results, only articles in English language were included. This resulted in 267 journal articles, of which 143 appeared in journals with an impact factor greater or equal than 1.[4]

To extract the relevant data with respect to the four research questions and relations stated above, the corresponding abstracts were scanned by evaluating whether empirical analyses in regard to one of the four relationships were conducted. Excluded were articles without empirical focus or with more specific settings such as ebay auctions or CEO reputation (i.e. without focus on corporate reputation), or corporate social responsibility-performance

[3] Based on a survey among U.K. chief executives, Hall (1992) finds that the most relevant intangible resources and assets for competitive advantage and business success are employee know-how and reputation.

[4] The same database search with the keyword “reputation” instead of “corporate reputation” led to a total of 2140 articles before refinement.