REPUTATION AND FINANCIAL PERFORMANCES OF A COMPANY*

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Abstract. As a kind of intangible asset, reputation allows the company to manage the expectations and needs of its stakeholders. It is just another tool in the efforts of each company to survive and improve its competitive position. This asset is difficult to acquire, and its formation usually requires high quality products over several years, solid financial results, constant innovation activity, responsiveness to the stakeholder demands, permanent technological advancement, high business success, etc. Reputation is a resource which cannot be imitated, and its strategic relevance in the resource portfolio is growing, because it can create differentiation and barriers in relation to competitors. The purpose of this paper is to examine the interdependence of reputation, as intangible resource of the company, and its financial performances. Two research questions are highlighted in this paper: whether actual financial performances affect the company's reputation and whether created reputation affects the financial performances of the company. The answers to these questions are given on the basis of empirical evidences of many studies realized in the previous period. The results of this paper will inevitably reveal significant interdependence, more precisely, the interplay of reputation and financial performances of the company. The contributions of the study are useful to managers in order not to forget the importance of a good reputation for superior financial performances, and also to direct more resources, time and efforts to the process of making a good reputation of their companies.

Key Words: reputation, intangible resources, financial performances, company.

INTRODUCTION

Contemporary business environment shows that a company has to be part of the society and play an active role in it. The reputation of the company is built over time and
it is the result of complex interactions and relationships between the company and its stakeholders. This means that the reputation is based on past actions, experiences, and reactions of stakeholders. In other words, reputation is based on the overall perception of the stakeholders associated with the company. Reputation means the development of these complex relationships over time, and it is hard to imitate in a short period of time (Grant, 1991). Reputation is built on the fundamental values of the company as a business system. For key stakeholders these values are: reliability, credibility, trust and responsibility. In recent years, companies have built and maintained their reputation by developing practices that integrate economic and social role in their corporate and/or business strategy. However, it should be noted that the reputation of the company is a very complex category (Dierick, Cool, 1989).

The reputation of a company combines two essential dimensions of efficiency. The first one is the valuation of a company. The second dimension is, however, evaluating the success of a company in achieving a certain level of corporate social responsibility (Fombrun, Van Riel, 1997). The assessment of company reputation is determined by matching the behaviour and expectations/preferences of its stakeholders.

Good reputation has strategic significance for the company (Dierickx, Cool, 1989). According to the resource-based view, firms with resources that are valuable and rare, have a competitive advantage and can expect to make a profit in the future (Barney, 1991). Also, the companies which assets are difficult to imitate can maintain superior financial performances in relation to their competitors. Intangible assets, such as good reputation, are crucial not only for abilities to create value in a company, but also because their intangible nature makes imitation by the competitors much more difficult. A good reputation is a valuable tool that allows the company to achieve long-term profitability or sustainable superior financial performance in relation to market rivals.

1. REPUTATION AND FINANCIAL PERFORMANCES OF COMPANY: THEORETICAL BASIS

Reputation is identified as a key intangible asset that adds value to a company (Clulow, Gerstman, Barry, 2003). However, it should be noted that intangible assets almost never create that value alone, but in combination with other company’s resources (Hall, 1993). The correlation between reputation and financial performance of companies can be realized in several ways: Generating profitable sales in a saturated market; Successful response to the actions of competitors; Attracting capital and strategic partners; Capturing new markets without any difficulties; High levels of customer satisfaction and repeat purchases; Attracting, motivating and retaining talented employees; Successful strategic reaction of company’s management, etc.

Because of its intangible nature, the reputation has been identified as a tool that helps a company to increase its intellectual capital. Intellectual resources are the basis of competitive advantage in the 21st century, because intellectual values can differ a company in relation to its competitors and provide better value creation for the customers. If a company wants to lead over the competition, a strong reputation must be its mandatory choice, and not an option.

Both internal and external factors affect the reputation. Internal factors include: the ability to communicate, openness, human resources treatment, innovation ability, manager reputation, adaptability to change, solving the social issues and environmental problems.
Company’s management has a significant role in shaping the reputation. External factors and stakeholders which impact on reputation are the following: customers, media, financial analysts, and government legislation (Lines, 2004).

A good reputation helps launch new products and enter new markets, by influencing consumers when choosing the same product in offered pallet of different market players (Fombrun, Van Riel, 2003). Companies that are trying to keep up with the competition, invest significantly in product innovation. Ability to design and launch a new product is the core of business or market success. Reputation is very important for these companies because consumers want to buy products from companies they have confidence. Namely, it is a confidence in the ability of the company for successful development of new products that customers want. So, the confidence is a necessary part of corporate reputation. The importance of a good reputation is reflected in reduction of transaction and communication costs with the market, and attraction of new customer’s confidence.

One of the main reputation objectives is the strategic positioning of a company and its products in the market in relation to competitors. This is possible because in the multitude of bidders similar products on the market, when there are no significant differences in their characteristics, the reputation is an essential element for better competitive differentiation.

Company reputation data come from managers, as well as from market analysts. These are two stakeholder groups whose estimations are extremely important. However, there are other groups of stakeholders (e.g., customers, employees, and suppliers) whose estimations also has implications to financial performances of the company.

Some studies (Davies, Chun, da Silva Vinhas, Roper, 2003) show that the attitudes of stakeholders in the enterprise are directly related to the key financial results, and that the image and identity of the company are relative. In addition, this research highlights that reputation management includes the harmonization of these two concepts, and this harmony affect financial results. The perception of the company as a ‘good citizen’ helps to build a reputation as an intangible value, and to make it contribute to its competitive advantage. Reputation deserves the most of the credit for the positive impact of business social dimensions on its financial performances (Orlitzky, 2005). Corporate social responsibility is a way and a form of investment, that creates opportunities for expansion and growth in the future (Husted, 2005).

Where does the good reputation come from? An interesting view is that reputation is determined by the value (quality) of the previous efforts and behaviours (Podolny, Phillips, 1996). In many cases, stakeholders in the enterprise can identify these efforts. Managers are involved in the activities of the so-called building the explicit reputation (e.g. advertising, sponsorship) to improve the reputation of their company (Fombrun, 1996). Managers also manage the associations which company exchanges with stakeholders to ensure the benefit from the reputation (Podolny, 1994). However, stakeholders do not evaluate directly a range of activities that lead to the formation of their impressions about reputation. They rely mainly on the financial performances achieved in the previous period, because they are a “sign” of the total respect of a company. A good reputation is the result of a construction process in the past, based on the actual financial performances. Also, good reputation is the result of current financial performances of the company. However, the reputation of the company in the present will reflect to financial performances in the future.
The variety of potential benefits, which are the result of a good reputation, point to the significant correlation between reputation and financial performance (Podolny, 1993). Reputation also serves as the basic product quality indicator of a company, and consumers are willing to pay more for products obtained from the company because of its high reputation, even though there is a high level of uncertainty in the market (Shapiro, 1983). A company with a good reputation may have an advantage because employees prefer to work in such firms. In addition, in the case of the company with high reputation, suppliers are less concerned about the contracted current and future transaction. A good reputation leads to lower costs of contracting and monitoring. Marketing literature also suggests that good reputation supports sales and its efficiency. It actually attracts potential customers and influences the retention of existing customers.

Srivastava, McInnish, Wood, Capraro (1997) prove in their research in 1997 that stakeholder groups consider a company with a good reputation, less risky in terms of investment, compared to the other companies with similar financial performances, but with a worse reputation. Reputation is particularly important in cases of realization of initial public offerings, takeovers, mergers, and strategic partnerships (McGregor, Slovic, Dreman, Berry, 2000). Reputation as an intangible asset, often valued implicitly, by the analysis and sometimes explicitly based on the market share price. Davies, Chun, Vinhas da Silva, Roper (2003) point out, however, that reputation contributes to the annual company income between 3 and 7.5%, so it can be considered as an investment, and not as a cost to the company.

2. METHODOLOGICAL FRAMEWORK AND HYPOTHESES

Many researchers have examined the relationship between corporate reputation and financial performances, and have found that there is a strong and a non-linear relationship between corporate reputation and financial performances (Inglis, Morley, Sammut 2006, Sanchez, Sotorrio 2007). Determining the relationship between reputation and financial performances means responding two questions: 1. Does company reputation have an impact on financial performance? 2. Do financial performances affect reputation? Reputation and financial performances may be interrelated categories. With this in mind, we define two starting positions and hypotheses:

H1. Financial performances of a company affect its reputation.

H2. The reputation of a company influences its financial performances.

It is necessary to stress the strategic benefits of a respectable reputation, which (at least in the short term period) can be difficult to imitate by competing firms. Also, it is important for the researchers to demonstrate that reputation has a financial impact on the company, because there is a need to prove economic viability, i.e. profitability of investment in communication programs to build the company image and reputation.

With the aim of analysing interdependence between reputation and financial performance, we use the previous results of relevant authors’ research in this field. Management theorists agree with one thing – reputation, as a unique and integral part of a company, is difficult to empirically evaluate because its base contains relationships which are almost impossible to statistically test (Rose, Thomsen, 2004).
3. IMPACT OF REPUTATION ON COMPANY’S FINANCIAL PERFORMANCES: RESEARCH RESULTS

Successful corporation management directs a significant part of financial resources and its efforts towards maintaining and improving the corporate reputation. Essentially, a good reputation has characteristics of intangible asset that can provide a competitive advantages, and which is indicated by the value of market-to-book ratio. When an investor buys shares of a corporation with a respectable reputation, she or he does not pay only for its real corporation property, but also for its reputation. In addition, since the consumer of a corporation products, in many situations, cannot confirm the quality of the products before the actual purchase moment, the respectable reputation can serve them as a sign or a signal of product quality (Kreps, Wilson, 1982). The corporation can build a brand, and after the formal trademark registration in the authorized institution, corporation receives exclusive property rights and the protection of its intellectual property. Brand (trademark) helps to solve so called, consumers’ “lack of information” problem about the quality of the product, but also it can be used as a sign of product quality. In addition, brand (trademark) is important for the consumers which are looking for the products with special qualities to reduce costs.

Company’s reputation affects the its relationship with other stakeholders, such as, for example, potential employees (Stuart, 2002). Thus, a company with a good reputation can attract competent people. In addition, a good reputation can reduce transaction costs, because it allows company to save on the cost of writing a complete contract (Williamson, 1985). On the other hand, the suppliers of a company will have lower costs of monitoring (Bromley, 2002).

Moreover, a strong corporate reputation can serve as a defense against market rivals, in a way that complicates their situation when competitors try to imitate the characteristics of companies with a superior reputation. Therefore, it does seem likely that the reputation of a company affects its financial performances. However, it should be noted that, when a company achieves outstanding financial performances, these performances can also have a positive impact on company’s reputation (McGuire, Schneeweis, Branch, 1990).

Rose and Thomsen (2004) has examined the relationship between company’s reputation and financial performances in Danish firms. They found that corporate reputation did not affect the value of market to book value ratio, and financial performances had a positive effect on reputation.

Data collected by Fombrun and Van Riel (2004) suggested that, for a period of five years, companies with a good reputation completely financially surpassed companies with a worse reputation.

Eberl and Schwaiger (2005) explore the relationship between corporate reputation of the company and future financial performances by using the data of German companies. They come to two important conclusions. The first one, financial performances in the past are only one component which affects reputation. The second one, the reputation is a "cognitive component" that has a positive impact on future financial performances, while there are strong evidences that "affective component" has a negative impact.

Vergin and Qoronfleh (1998) following the Fortune’s list, highlighted an evidence of the positive role of corporate reputation in value creation. Jones, Jones and Little (2000) noted that, in the case of a sudden and unexpected drop in the share value, a company with a good reputation suffered less decline in the share price. They also noted that when
the crisis is strong, investors were in panic how to overcome the crisis. Investors solved
this situation by investment decisions, since corporate reputation could not mitigate the
decline in share value on the stock exchange. Roberts and Dowling (1997) also confirmed
that reputation allowed companies to keep better financial performances for a long period
of time (so called, the transfer effect).

Several different studies confirmed the connection between reputation and revenue.
Graham and Bansal (2007) found in their research that an airline company reputation
grew for 1%, and its customers were willing to pay additional 18 dollars for a ticket.
Herremans et al. (1993) examined whether large U.S. manufacturing companies with
a better reputation in corporate social responsibility could outperform companies with a
worse reputation in the six-year period. They measured the following financial performances
(Herremans, Akathaporn, McInnes, 1993): operating profit margin, net profit margin, return
on total assets, and return on equity. This study featured 21 branches, based on Fortune’s
survey about the corporate reputation for the period 1982-1987. The results were
consistent with the hypothesis that the company reputation was positively related to
financial performances, which was confirmed by profitability indicators.

Roberts and Dowling (2002) explored the relationship between corporate reputation
and high financial performances. Their data set was based on a sample of most U.S.
corporations during the period from 1984 to 1998 of the Fortune magazine report. This
study examined whether a good reputation allowed the company to achieve profitability
or sustain other superior financial performances. They used annual data about the
company’s profitability, the market to book value ratio, and company size. They
discovered that firms with excellent reputation were more likely to maintain financial
performances over time. In addition, Brown (1998) argued that a bad reputation could
signal the investors about the possible catastrophe, and in the moment when it happened,
the company would not have necessary public support to overcome the crisis.

The complexity of the relationship between corporate reputation and financial
performances is also pointed out by Fryxell and Wang (1994). Reputation is essential for
corporations in their intention to protect their image and survive in the marketplace. This
is important for risk management in corporations when stock markets are volatile, and
when the investors, instead of rational decisions, make the decisions driven by fear.
Corporate management can enhance reputation and influence investors’ decisions if it
reports on financial and social responsibility performances in the proper way.

4. IMPACT OF FINANCIAL PERFORMANCES ON COMPANY’S REPUTATION:
RESEARCH RESULTS

Sobol and Farrell (1988) revealed the potential impact of financial performance on
reputation. They conducted study and introduced earnings per share ratio, price earnings
ratio and dividend per share for the ten-year period of time. The results showed that the
relevance of financial performance varies according to different attributes of Fortune
survey and varies from company to company. During the second part of the study, the
above mentioned authors presented possible crucial factors that affected the reputation.

Fombrun and Shanley (1990) represented a broader concept of reputation, that observed
a reputation as an overall perception of company’s performances by its stakeholders. The
ultimate objective of their study was to illustrate the diversity of information sources
stakeholders used to evaluate and determine reputation. They chose accounting performances, profitability, and risk in the past, and market value of the company as the most important variables. Fombrun and Shanley (1990) argued that companies with a higher share price and better reputation, and also had better rating which made reputation an important factor for investors.

Brown and Perry (1994) confirmed the relationship between the return on assets (ROA) and reputation. Hammond and Slocum (1996) stressed that the delay period of the financial performances impact on reputation is from 5 to 10 years. Hammond and Slocum examined the impact of the past period financial performances on corporate reputation in the future (Hammond, Slocum, 1996). Based on research data of Fortune magazine for the period since 1981 to 1993, aforementioned authors pointed out that financial performance indicators, such as profitability and profit margin, affected the future reputation moderately.

Dunbar and Schwalbach (2000) also explored the relationship between reputation and financial performance, but based on the research in 63 German companies in the ten-year period. They found that the financial performances in the past had a strong impact on the future reputation. Many German companies have a relatively stable reputation, so reputation had a positive impact on the overall financial business in Germany. Financial performances of German companies had immediate and delayed effects on corporate reputation.

Sabate and Puente (2003) pointed out that the relationship between reputation and financial performances included the answers on two questions, whether the relationship was positive or negative and whether the reputation had an impact on financial performances, or vice versa. They pointed out that, in developed countries, the positive impact of financial performances on corporate reputation had always been confirmed. According to Neville et al. (2005), the financial performances of a company were in relation with its reputation. Moreover, they suggested that a positive relationship between corporate reputation and financial performances would contribute to increased competitiveness.

CONCLUSION

Reputation is the effect of the past commitments, efforts, behaviours of the company as a whole, and its managers and other employees, as well as the effect of current results, achievements, quality, and success. Managers should not consider the reputation as anything that simply happens spontaneously. Ignoring the role of intangible items in value creation for customers and increasing the market value of a company, the management takes the risk of poor management of the most important elements of intellectual capital, and it is the reputation. Good company reputation is a distinctive competitive ability, which inevitably leads to a better market position. High-quality intangible assets are associated with maintaining superior business performances.

Previously mentioned elaborations point to the affirmative answers to both research questions or hypotheses in this paper. Namely, the results of many studies have shown there is an impact of the reputation on financial performance, and vice versa. The company has more chance to keep superior performances over time if it has a relatively good reputation. Company’s reputation has a strong impact on profit, rate of return and other financial performances. This emphasizes the importance of strengthening the reputation. Companies exert to improve profitability and other financial performances,
and then, consequently, to maintain and strengthen the already build reputation. Good reputation, in turn, makes it easier for companies to maintain a good business (financial) performances over time. Good financial performances allow the company to sustain its reputation, and then contribute to the growth of its market value.

REFERENCES
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REPUTACIJA I FINANSIJSKE PERFORMANSE PREDUZEĆA

Kao jedna vrsta nematerijalne imovine, reputacija omogućava preduzeću da upravlja očekivanjima i potrebama svojih stejkholdera. Ona je jedno od važnijih alata u naporima svakog preduzeća da se održi i unapredi svoju konkurentska poziciju. Ova imovina se teško stiče, pa njeno kreiranje obično zahteva visok poslovni uspeh, itd. Reputacija se kao resurs ne može imitirati, pa njena strategski značaj u portfoliju resursa jednog preduzeća raste, jer ona može da stvara diferencijaciju i barijere u odnosu na konkurente. Svra ovog rada je da istraži međuzavisnost reputacije kao nematerijalnog resursa preduzeća i njegovih finansijskih performansi. Dva istraživačka pitanja istaknuta su u ovom radu: da li ostvarene finansijske performanse utiču na reputaciju i da li izgrađena reputacija utiče na finansijske performanse preduzeća. Odgovori na ova pitanja mogu se
dobiti detaljnijom analizom dokaza koje pružaju mnogobrojne empirijske studije realizovane u prethodnom periodu. Rezultati ovog rada neminovno ukazuju na izraženu međuzavisnost, tačnije, međusobni uticaj reputacije i finansijskih performansi predueća. Doprinosi sprovedenog istraživanja su od koristi menadžerima kako bi bolje razumeli značaj dobre reputacija za superiornu finansijsku performanse i kako bi više resursa, vremena i napora usmerili u proces izgradnje dobre reputacije svoje kompanije.

Ključne reči: reputacija, nematerijalni resurs, finansijske performanse.