

REPUTATION, FINANCIAL PERFORMANCE, AND INDUSTRY COMPETITION

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ABSTRACT

In this study, we re-examine the relationship between reputation and financial performance in a unique setting, namely industry intensity. Using a sample of Most Admired Companies by Fortune magazine from 2006–2008, we show that industry competition partially changes the dynamic between financial performance and corporate reputation. While more reputable firms generate better operating outcomes regardless of industry competition, the effect of prior financial performance on subsequent reputation is moderated as competition intensifies. Specifically, in non-competitive sectors, financial outcome is still a dominating factor in evaluating future corporate reputation. The influence, however, is diluted in competitive sectors as information asymmetry is eased. Our empirical findings advance the understanding of the relationship between reputation and performance as well as its interaction with other institutional features.

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KEYWORDS: Corporate Reputation, Financial Performance

INTRODUCTION

Researchers and practitioners have, for decades, concluded that corporate reputation is a valuable asset owned by a company. Reputation is difficult to imitate and cannot be earned in a quick fashion. Therefore, more reputable firms tend to outperform their peers in both profitability (Roberts and Dowling, 2002) and equity returns (Anderson and Smith, 2006). Moreover, such positive influence is bilateral. As good reputation provides firms with a variety of competitive advantages, strong operating outcomes also further advance firm's future reputation (Koch and Cebula, 1994, Flanagan et al, 2013).

Reputation, as put forward by Formbrun (1996), is "a perceptual representation of a company's past actions and future prospects that describes the firm's overall appeal to all of its key constituents when compared with other leading rivals." Reputation is constantly employed and evaluated by outsiders who identify this institutional feature based on their prior experiences with the company. Such an evaluation process, however, is limited to a certain extent. Outsiders, regardless of their interactions with the firm, cannot access the complete set of information which could be used to identify all reputation driven activities. Therefore, independent or other easily available metrics, such as financial performance, becomes more applicable. Researchers find supportive evidence that cross-sectional variation of reputation score is related to prior operating results (Brown and Perry, 1994). Meanwhile, reputation strengthens subsequent financial performances as well. As a valuable asset, a good reputation is difficult to replicate. It, thus, could provide competitive advantages through a range of channels, such as low labor costs, high productivity, and favorable brand recognition (Gupta, 2002, Rose and Thomsen, 2004, Awang and Jusoff, 2009). Extra economic rents could be extracted through any of these channels. Roberts and Dowling (2002) present evidence that, reputational advantages are sustainable and reputable firms' strong financial performance is persistent over time. Taken together, there exists a virtuous and recursive relationship between corporate reputation and financial performance.

Nevertheless, the performance-reputation relationship has been largely examined in an isolated framework. Evidence of confounding factors, which could alter this relationship unilaterally or bilaterally, is limited. For instance, industry and year effects are only used as control variables in prior studies. Dunbar and Schwalbach (2000) show that, firm reputation varies significantly among different industries when they analyze a sample of German companies. Flanagan et al (2013) confirm the existence of an industry effect but do not show whether such effect *weakens* or *strengthens* the performance-reputation relationship. Only a few studies have addressed this issue. For instance, Sanchez and Sotorrio (2007) argue that the sector of activity, strategy of differentiation, competitive intensity, and the power of stakeholders may, separately or aggregately, moderate the relationship between reputation and financial performance. Using a small sample of 88 Spanish firms, they present evidence that industry intensity weakens the reputation-to-performance relationship. The present study intends to extend such findings. Specifically, using a more recent and comprehensive dataset, we examine *how* industry competitiveness affects the bilateral relationship between reputation and financial performance. We empirically test if such relationship would change as competition intensifies/eases by employing the Herfindahl Index framework to measure industry intensity (Giroud and Mueller, 2011). Different from the existing literature, this study focuses on the dynamic between *other* important institutional features and the reputation-performance relationship, rather the latter itself. To our knowledge, no other studies have provided similar empirical findings using comparable data set.

Our results show that good reputation still positively relates to subsequent firm performance. More reputable firms perform better than their less reputable peers regardless of industry intensity. Both return on asset (ROA) and Tobin's q are higher when previous year's reputation score is higher. One unit increase in reputation score will boost the ROA by 1.1% in the following year. Industry intensity presents no statistically significant impact on either ROA or Tobin's Q. Neither does it change the positive influence of reputation on performance. The interaction term between prior reputation and industry intensity is not economically significant in the multivariate regression, even though the sign is negative as we conjectured. On the other hand, competition alters the performance-to-reputation relationship. Specifically, the effect of financial performance on reputation is more palpable in non-competitive sectors than the competitive ones. Without competition, industry monopoly reinforces the role of prior financial outcomes in evaluating future reputation. However, such effect wanes in competitive sectors. We argue that, as competition increases, information becomes more transparent and easier to extract; therefore, the reputation assessment process becomes more efficient and its reliance on operating results is alleviated.

On the contrary, information asymmetry still prevails when competition is limited. External stakeholders have to depend on conventional or independent benchmarks, such as financial outcomes in particular, to assess a firm's reputation. We use several different approaches to control for endogeneity in our model specifications and our results broadly hold. In sum, industry competition increases the speed of information flow and reduces information asymmetry, which thereby eases the dominant role of operational results in evaluating firm reputation. However, a good reputation still results in favorable financial outcomes regardless of industry intensity. Our findings provide new evidences about *how* institutional features change the bilateral reputation-performance relationship. We also shed light on future research that confounding effects need be taken into account when studying corporate reputation and its influences on firm performance. We review the literature background and develop main hypotheses in Section 2. In Section 3, we summarize our sample and present descriptive statistics. Our findings are reported in Section 4 and followed by conclusion remarks in Section 5.

LITERATURE REVIEW

In the management literature, numerous studies have examined and confirmed the recursive and positive relationship between reputation and financial performance. In the stakeholder theory, Freeman (1984) argues that, firms with better relationships with their stakeholders are more successful over time because transaction costs are reduced as these relationships improve. Similarly, the resourced-based view (RBV)

argues that, favorable reputation or corporate image is considered as a valuable but intangible resource. It helps companies differentiate themselves, in a positive way, from their peers; therefore it provides competitive edges (Surroca, Tribo and Waddock, 2010). Prior studies also confirm, empirically, that a good reputation leads to better future operating results (McGuire et al, 1990, Dunbar and Schwalbach, 2000, Rose and Thomsen, 2004). On the other hand, empirical evidence attests that prior financial performances contribute to subsequent reputation (Fombrun and Shanley, 1990) as well. Koch and Cebula (1994) present evidence that profitability and other firm characteristics can explain about 30% of the variations in future reputation. Brown and Perry (1994) show that 55% of the variations in Forbes Most Admired Companies reputation scores come from previous financial results. Using more recent data, Flanagan et al (2013) reconfirm Brown and Perry (1994)'s findings and show a weaker but still significant relationship between prior returns on asset (ROA) and future reputation scores. Like other capital-intensive assets, reputation demands a significant amount of financial inputs. Firms with better operating outcomes tend to have more spare resources for reputation-building activities. For instance, focusing on a subset of reputation (namely social responsibility), Waddock and Graves (1997) assert that better operating outcome results in a surplus of financial resources. These resources provide firms the ability to consider social issues and to make socially responsible contributions.

In finance/accounting literature, the benefit of obtaining a good reputation is justified by the alleviated agency problem and its related costs. Jensen and Meckling (1976) view a firm as a nexus of contracts. If a firm can minimize the cost of these contracts, its value will be maximized. Reputation helps firms build trust with various vital stakeholders (Wicks, Berman, and Jones, 1999), such as employees, vendors, and customers. As trust improves, the cost of contracting with these external parties will be reduced. Eventually, the company, as well as its owners, can collect financial benefits from these savings. Given the separation between ownership and management among large U.S. corporations, agents' reputation concern and their behaviors could also significantly affect corporate performance. Therefore, instead of focusing on firm reputation itself, early empirical work in finance/accounting primarily examines agents, such as managers or directors, whose reputation seems critical to their own future employment opportunities and compensations. For instance, Fama and Jensen (1983) highlight that outsider directors are often motivated by their reputation in the market of directorship. They tend to align their interests with shareholders rather than managers. Practitioners in financial intermediaries, such as analysts (Jackson, 2005, Fang and Yasuda, 2011) and underwriters (Jo et al, 2007, Ljungqvist et al, 2007), are also found to be concerned about their reputation. Recently, reputation research has been extended to corporate behaviors and the decision-making process. Siegel (2005) addresses how the cost of financing is associated with firm reputation.

Cao et al (2012) indicate that more reputable firms are less likely to misstate their financial statements and more cautious about the quality of their financial reporting. Lastly, favorable reputation seems to lead to better-than-average stock performance as well. Using a portfolio of Forbes Most Admired Companies, Anderson and Smith (2006) show that reputable firms outperform market indices over time. Similarly, Filbeck and Preece (2003) document positive stock market responses when companies are added to Fortune's "100 Best Companies to Work For" list. Taken two strands of literature together, empirical evidence supports the conjecture that, corporations and their managers take reputation into consideration when strategic decisions are made. Reputation is often assessed, externally, based on prior financial performance; in return, good reputation enhances firm operating outcomes subsequently. Such virtuous relationship eventually benefits shareholders by increasing firm values over time.

However, existing empirical research of performance-reputation relationship pays little attention to the effect of contingent factors or institutional features, such as industry characteristics. For instance, Dunbar and Schwalbach (2000) shows that certain industries have better reputation than others in general, but they do not address any specific consequence. When studying the persistence of superior financial performance stemming from good reputation, Roberts and Dowling (2002) only controls market-to-book ratio and firm size. Similarly, Waddock and Graves (1997) ignore the industry feature when analyzing the causation

between social performance and financial outcome. As summarized by Waller (2010), industry feature and other firm characteristics are often used as control variables rather than any focal point in most reputation studies. Even in a more recent study by Flanagan et al (2013), industry is merely controlled by a dummy variable. Related discussion is still very limited. We try to fill this void in the present study.

We argue that, though many of these institutional features are exogenous by nature, they all interact with performance, reputation, or both to a certain extent. In the present study, we investigate the effect of industry competition to the bilateral relationship between reputation and performance. We contend that, since operation and consumer perceptions vary greatly among different sectors, industrial feature could change the dynamic between performance and reputation. For instance, many consumers favor reputable companies over non-reputable ones when they choose products or service. Such preference is particularly evident in the competitive sector, where goods and services tend to be homogenous and customers can easily switch to different providers at minimal or no cost. Therefore, less reputable companies in these sectors may have to use more resources to attract customers and to compete with their reputable counterparts. These extra efforts eventually result in inflated operating costs and low profit margins. Contrarily, such pressure could be muted in non-competitive sectors. Reputation is rarely a concern when customers have few options (Neville et al, 2005). Firm performance becomes less elastic to customers' perceptions of the company *ceteris paribus*. Several studies in finance (Schmidt, 1997, Raith, 2003) provide theoretical grounds for the argument. They show that, industry competition in fact provides monetary incentives to managers. It saves monitoring costs by substituting for other costly mechanisms, such as corporate governance or reputation building. As competition increases, managers tend to work harder and try to produce better financial results regardless. When competition is moderate or low, managers might have to be motivated by other means. Therefore, we conjecture that the reputation-to-performance relationship weakens as industry competitiveness increases (Hypothesis 1). Within the same vein, Giroud and Mueller (2011) examine the relationship between corporate governance and firm value given different levels of competition. They find the relationship varies as industry intensity changes.

In competitive sectors, both firm value and operational results are positively linked to governance practice. Conversely, such correlation becomes insignificant in non-competitive sectors. As highlighted by Musteen et al (2010), corporate governance and reputation are positively correlated. They share many similarities in terms of costs and effects. We, thus, expect comparable industry effects would be found in the reputation-to-performance relationship. In the literature, the understanding of performance-to-reputation has been primarily theoretical. Reputation is developed through the interaction with different external constituents. To certain groups, financial outcome is the primary, if not the only, reliable and available benchmark; to others, additional channels may prevail. Nonetheless, superior financial performance alone does not necessarily guarantee a good reputation. For instance, Walmart is well regarded for its efficient operating style and remarkable stock returns among retailers. It is also infamous for its low employee benefits coverage and substandard workers' compensation.

As emphasized by Fomburn (1996), reputation is the *aggregated* perception of all stakeholders. Financial outcome only represents the interest of a certain group of stakeholders, not all of them. Therefore, Walmart's financial performance and notable stock returns do not necessarily translate into a good overall reputation. Empirically, Brown and Perry (1994) and Flanagan et al (2013) are among the few ones that examine the performance-to-reputation relationship. Both provide supportive evidence. Specifically, Brown and Perry find 55% of the variance of reputation rating can be explained by financial outcomes. Using more recent data, Flanagan et al (2013) confirms Brown and Perry's earlier findings after controlling for industry effects. However, the aim of this study is not to refine the causation between performance and reputation. Rather, we try to understand whether such causation varies given different industry features (Hypothesis 2). Building reputation generally is no different from acquiring other valuable assets. Presumably, strong financial performances lead to adequate capital surplus, which provides more capital for reputation building. However, it is unclear how industry intensity interacts with such causation. In

competitive sectors, firms may be more willing to gain reputation but are subject to limited capital due to low profitability. On the other hand, firms in non-competitive sectors may be less interested in building reputation even when they have sufficient financial means. Their reputation may not directly reflect their financial results.

DATA AND METHODOLOGY

Sample Selection

Walker (2010) posits the difficulty in operationalizing corporate reputation. Following most studies in business literature, we choose the reputation score from Fortune's Most Admired Companies (FMAC hereafter) for the following reasons. First, among a variety of reputation surveys, FMAC has the longest history. Fortune has updated the list each year since its inaugural release in 1983. No other vendor provides comparable data with similar longitude. Second, FMAC takes into account the interest of different stakeholders. FMAC considers eight criteria: innovation, people management, financial soundness, the quality of management, the use of corporate assets, social responsibilities, long-term investment, and the quality of products/services. Many of these factors do not appear to be driven by firms' financial results. Finally, FMAC incorporates opinions from various external assessors including financial analysts, corporate leaders, and industry experts. Since reputation is the collective perception of a company, wider coverage commands better data reliability and fewer unidentified biases. We obtained the FMAC lists from 2006-2008 as our main sample and excluded entries that are non-domestically resided or privately hold. We, then, extracted financial data and monthly stock returns from 2005 to 2009 from the Compustat database and CRSP, respectively. Only cases with available financial information and stock returns are remained. Our final sample includes 333 firm and 614 firm-year observations. Compared to the sample used in a similar study by Sanchez and Sotorio (2007), ours is larger and more recent, which allows us to draw better conclusions.

Summary Statistics

Table 1 summarizes the industry distribution of our sample using Fama-French (FF) 48 specifications. We download Fama-French 48 industry descriptions from Professor Kenneth French's website and then assign each firm's industry code based upon its SIC code extracted from Compustat. No industry dominates the entire sample. Several industries only have one presence, such as food products (FF 1) and aircraft (FF 25). On the other hand, business service sector (FF 34) has 24 firms, the highest among all, but still counts merely 7.21% of the entire sample cases. Trailing the business service sector are wholesale (FF 41) and retail (FF 42) industries, which has 20 cases respectively as shown in Table 1. Overall, our sample represents companies from a broad background.

Sample descriptive statistics of sample cases are presented in Table 2. We first reported each variable's summary statistics by year (2005-2009) and then we show the universal average of the entire sample. Following the literature, we proxy financial performance using return on assets (ROAs) and Tobin's Q. ROA is defined as net income scaled by total assets, while Tobin's q is the sum of the book value of debt and the market value of equity scaled by total assets. As shown in Panel A of Table 2, the average ROA varies from 2005 to 2009. It peaked at 6.87% in 2006 and bottomed out at 2.65% in 2008. Such pattern matches the general economic cycle as the U.S. economy went through a major recession during our measurement period. Similarly, Tobin's q also topped in 2006 at 1.97 and dipped to the lowest point at 1.44 in 2008. Median statistics of both measures are following the same fashion. In untabulated results, we compute operating profitability as an alternative to ROA and Tobin's Q. Similarly, average operating profitability dropped from 18% in the pre-recession period to near 15% in post-recession periods.

Table 1: Summary of Industry Distribution

Fama-French Industry Code	Count	Percentage
0	3	0.90
1	1	0.30
2	9	2.70
4	2	0.60
5	3	0.90
6	2	0.60
7	3	0.90
8	5	1.50
9	3	0.90
10	6	1.80
11	6	1.80
12	6	1.80
13	7	2.10
14	6	1.80
15	3	0.90
17	6	1.80
18	8	2.40
19	8	2.40
21	9	2.70
22	4	1.20
23	10	3.00
24	4	1.20
25	1	0.30
26	1	0.30
27	1	0.30
28	2	0.60
29	1	0.30
30	12	3.60
31	12	3.60
32	12	3.60
33	3	0.90
34	24	7.21
35	13	3.90
36	14	4.20
38	8	2.40
39	4	1.20
40	18	5.41
41	20	6.01
42	20	6.01
43	8	2.40
44	14	4.20
45	17	5.11
46	2	0.60
47	12	3.60
Total	333	100

Table 1 summarizes the industry distribution of our sample using Fama-French 48 industry specification. We obtain each firm's 4 digit industry code from Compustat and assign Fama-French 48 industry code using the algorithm from Professor French's data portal.

Following Giroud and Mueller (2011), we use the Herfindahl Index (HI) to measure the level of competition in each industry, which is defined by Fama-French 48 industry classifications using each firm's SIC code from Compustat. For every industry in each fiscal year, we compute the HI as:

$$HI_{kt} = \sum_{i=1}^{N_k} s_{ikt}^2$$

where s_{ikt} is the market share of company i in industry k in year t . s_{ikt} is calculated as each company's annual sales scaled by the aggregated sales of all companies within the same Fama-French industry. Then, we sum the squared market share of all companies in the same industry to obtain the Herfindahl Index. Summary statistics of the HI is reported in Panel B of Table 2. Industry competitive intensity remains stable

over the 2006–2008 periods with the mean around 0.066 and the median close to 0.055. No visible variation is presented. In our sample, the most concentrated industry is the defense sector, which is dominated by Lockheed Martin Corp. Companies in utility and financial service are facing more competition compared to others. Lastly, we report the descriptive statistics of reputation score in Panel B of Table 2. Similar to the findings in Roberts and Dowling (2002), reputation scores are stable over years. From 2006 to 2008, average score is close to the universal average (6.902). The standard deviation (untabulated) of reputation score is only 0.68 during this time period. In Panel C of Table 2, we supplement the descriptive statistics of two control variables, market capitalization and market adjusted return, which will be employed in the regression analysis. In general, our sample represents a group of large and established companies, which have relatively stable reputation score during 2006–2008 period and cover variety of industries. Their financial performance greatly matches the macroeconomic condition in the United States from 2005 to 2009.

Table 2: Descriptive Statistics of Our Sample

	Year	N	Mean	Median	Minimum	Maximum
Panel A: Financial Performance						
ROA	2005	294	2.65%	4.97%	-85.26%	27.30%
	2006	320	6.87%	6.04%	-14.09%	50.34%
	2007	312	5.52%	5.54%	-46.14%	40.91%
	2008	294	2.65%	4.97%	-85.26%	27.30%
	2009	290	3.74%	3.77%	-48.33%	76.91%
	All	1,537	5.18%	5.29%	-85.26%	76.91%
Tobin's Q	2005	294	1.44	1.21	0.45	4.73
	2006	320	1.97	1.59	0.86	13.73
	2007	312	1.86	1.51	0.65	8.64
	2008	294	1.44	1.21	0.45	4.73
	2009	290	1.57	1.34	0.59	6.25
	All	1,536	1.77	1.45	0.45	13.73
Panel B: Competition and Reputation Score						
Competition	2005	294	0.066	0.054	0.016	0.726
	2006	320	0.064	0.052	0.013	0.798
	2007	312	0.067	0.053	0.015	0.771
	2008	294	0.066	0.054	0.016	0.726
	2009	290	0.067	0.058	0.020	0.726
	All	1,537	0.066	0.053	0.011	0.804
Reputation	2006	203	6.91	6.91	5.22	8.60
	2007	217	6.86	6.92	4.45	8.53
	2008	216	6.93	6.96	5.25	8.48
	All	636	6.90	6.93	4.45	8.60
Panel C: Market Capitalization and Index-Adjusted Stock Returns						
Market Capitalization	2005	294	20,977	7,987.4	30.054	397,234
	2006	320	30,660	14,189	257.40	439,013
	2007	312	32,023	13,955	0.0156	504,240
	2008	294	20,977	7,987.4	30.054	397,234
	2009	290	24,867	10,271	75.419	322,334
	All	1536	27,349	11,875	0.0156	504,240
Adjusted Returns	2005	294	-0.53%	0.16%	-56.69%	89.31%
	2006	320	2.00%	-0.48%	-72.71%	136.70%
	2007	312	-2.57%	-4.16%	-93.09%	132.87%
	2008	294	-0.53%	0.16%	-56.69%	89.31%
	2009	289	12.56%	5.28%	-119.11%	316.86%
	All	1535	3.44%	-0.15%	-119.11%	316.86%

Table II present the summary statistics of our samples. In Panel A, we present the descriptive statistics of return on asset (ROA) and Tobin's Q from 2005 to 2009. ROA is defined as net income scaled by total assets and Tobin's q is the sum of the book value of debt and the market value of equity scaled by total assets. Panel B reports the average competition index from 2005 to 2009 and the reputation score from 2006 to 2009. Competition index is calculated using the Herfindahl Index framework based on each year's sales. Finally, we compute the average market capitalization and index adjusted annual stock returns from 2005 to 2009. The summary statistics are report in Panel C. All financial information is extracted from CompuStat and stock returns are obtained from CRSP. Reputation score is acquired from Fortune Magazine.

Before we examine how industry competition changes the relationship between reputation and performance in a dynamic framework, we first test the correlation among our key variables, including ROA, reputation

score, and industry intensity along with a set of standard control variables. As mentioned in the prior literature, firm financial performance is autocorrelated. Therefore, we add the lead and lag variation of both ROA and Tobin’s Q and results are summarized in Table 3. As shown in Panel A, reputation is related to ROAs in different time periods with coefficients ranging from 0.199 to 0.2938. All coefficients are statistically significant. Similar pattern, presented in Panel B, holds if we use Tobin’s Q to measure performance instead. Coefficients range from .02073 to 0.2680, which is close to the numbers reported in Panel A of Table 3. Interestingly, competition intensity alone does not correlate with either performance or reputation. None of the coefficient is statistically significant. Only the log transformation of market capitalization appears to negatively relate to competition as large companies are more likely to exist in more competitive sectors. At first glance, industry competition does not seem to directly impact either financial performance or reputation. We further explore how this factor interacts with the relationship between performance and reputation in a multivariate framework.

Table 3: Correlation Analysis

Panel A: Return on Assets, Reputation, and Competition								
	ROA _{t-1}	ROA	ROA _{t+1}	Reputation	Competition	Market Capitalization	Sales Growth	Leverage
ROA _{t-1}	1.0000							
ROA	0.4881 <i>0.0000</i>	1.0000						
ROA _{t+1}	0.4935 <i>0.0000</i>	0.5944 <i>0.0000</i>	1.0000					
Reputation	0.1966 <i>0.0000</i>	0.2399 <i>0.0000</i>	0.2938 <i>0.0000</i>	1.0000				
Competition	0.0372 <i>0.3574</i>	0.0148 <i>0.7097</i>	-0.0179 <i>0.6518</i>	0.0129 <i>0.7453</i>	1.0000			
Market Capitalization	0.3244 <i>0.0000</i>	0.2957 <i>0.0000</i>	0.2286 <i>0.0000</i>	0.3475 <i>0.0000</i>	0.0900 <i>0.0232</i>	1.0000		
Sales Growth	0.1676 <i>0.0000</i>	0.2740 <i>0.0000</i>	0.1640 <i>0.0000</i>	0.1054 <i>0.0078</i>	-0.0420 <i>0.2900</i>	0.1832 <i>0.0000</i>	1.0000	
Leverage	-0.1983 <i>0.0000</i>	-0.3123 <i>0.0000</i>	-0.3092 <i>0.0000</i>	-0.1458 <i>0.0002</i>	0.0547 <i>0.1684</i>	-0.3000 <i>0.0000</i>	-0.0913 <i>0.0213</i>	1.0000

Panel B: Tobin’s Q, Reputation, and Competition								
	Tobin’s Q _{t-1}	Tobin’s Q	Tobin’s Q _{t+1}	Reputation	Competition	Market Capitalization	Sales Growth	Leverage
Tobin’s Q _{t-1}	1.0000							
Tobin’s Q	0.8279 <i>0.0000</i>	1.0000						
Tobin’s Q _{t+1}	0.8154 <i>0.0000</i>	0.8771 <i>0.0000</i>	1.0000					
Reputation	0.2073 <i>0.0000</i>	0.2071 <i>0.0000</i>	0.2680 <i>0.0000</i>	1.0000				
Competition	-0.0101 <i>0.8020</i>	-0.0313 <i>0.4312</i>	-0.0545 <i>0.1705</i>	0.0129 <i>0.7453</i>	1.0000			
Market Capitalization	0.2398 <i>0.0000</i>	0.2676 <i>0.0000</i>	0.2026 <i>0.0000</i>	0.3475 <i>0.0000</i>	0.0900 <i>0.0232</i>	1.0000		
Sales Growth	0.2278 <i>0.0000</i>	0.2605 <i>0.0000</i>	0.2525 <i>0.0000</i>	0.1054 <i>0.0078</i>	-0.0420 <i>0.2900</i>	0.1832 <i>0.0000</i>	1.0000	
Leverage	-0.2746 <i>0.0000</i>	-0.2756 <i>0.0000</i>	-0.2465 <i>0.0000</i>	-0.1458 <i>0.0002</i>	0.0547 <i>0.1684</i>	-0.3000 <i>0.0000</i>	-0.0913 <i>0.0213</i>	1.0000

Table 3 presents the correlation analysis among performance measure, reputation score, competition index, the log transformation of market capitalization, sales growth, and the leverage. Panel A and Panel B use return on assets (ROA) and Tobin’s Q to proxy performance respectively. In addition, we include the lead and lag transformation of ROA and Tobin’s Q to control for autocorrelation. All variables are defined as in Table 2.

RESULTS AND DISCUSSION

Reputation-to-Performance

We, first, test the reputation-to-performance relationship with industry intensity in Model I, II and III. Following McGuire et al (1990) and Roberts and Dowling (2002), in the base model (Model I) we regress financial performances onto reputation score and a set of control variables, including the growth rate of sales, financial leverage, and industry and year dummies. All independent variables are winsorized at 1% to exclude any outlier, and then lagged for one year to control for endogeneity. We also cluster the error terms for robustness. As shown Panel A of Table 4, the coefficient of reputation is 0.011 and highly significant (t-stat = 2.13). Economically, one unit increase in reputation score will boost next year's ROA by 1.1% after controlling for size, sales growth and financial leverage. In addition, sales growth helps improve performance while financial leverage will decrease firm operating results, which is consistently with the findings in prior literature.

$$ROA_{i,t} = \alpha + \beta_1 \times Reputation_{i,t-1} + \beta_2 \times Size_{i,t-1} + \beta_3 \times Sales\ Growth_{i,t-1} + \beta_4 \times Leverage_{i,t-1} + \beta_5 \times Industry\ Dummy_{i,t-1} + \beta_6 \times Year\ Dummy_{i,t-1} + \varepsilon_{i,t} \quad 1$$

In order to test the joint effect of reputation and industry intensity on performance, we add the Herfindahl Index as an additional independent variable in Model II, which is specified as the following,

$$ROA_{i,t} = \alpha + \beta_1 \times Reputation_{i,t-1} + \beta_2 \times Industry\ Intensity_{i,t-1} + \beta_3 \times Size_{i,t-1} + \beta_4 \times Sales\ Growth_{i,t-1} + \beta_5 \times Leverage_{i,t-1} + \beta_6 \times Industry\ Dummy_{i,t-1} + \beta_7 \times Year\ Dummy_{i,t-1} + \varepsilon_{i,t} \quad 2$$

Results are reported in the fourth and fifth columns of Panel A in Table 4. It appears that adding industry intensity makes almost no additional explanatory power as compared to the results from Model I. R-square remains the same at 0.1405 for both models. More importantly, the coefficient of the industry intensity is only 0.003 and statistically insignificant. The coefficients of the remaining independent variables also broadly unchanged compared to Model I. Overall, we do not find that that industry competition show any *direct* impact on firms' financial performance. To further test if industry competition shows any marginal effects onto the reputation-to-performance relationship, we include an interaction term between industry intensity and reputation as shown in Model III. We contend that, if competitiveness increases the importance of reputation, we expect the coefficient, β_3 , of the interaction term to be negative, i.e. higher intensity, will augment the positive influence of reputation toward financial outcomes. Our regression model is specified as:

$$ROA_{i,t} = \alpha + \beta_1 \times Reputation_{i,t-1} + \beta_2 \times Industry\ Intensity_{i,t-1} + \beta_3 \times Industry\ Intensity_{i,t-1} \times Reputation_{i,t-1} + \beta_4 \times Size_{i,t-1} + \beta_5 \times Sales\ Growth_{i,t-1} + \beta_6 \times Leverage_{i,t-1} + \beta_7 \times Industry\ Dummy_{i,t-1} + \beta_8 \times Year\ Dummy_{i,t-1} + \varepsilon_{i,t} \quad 3$$

As shown in the last two columns of Panel A in Table 4, adding the interaction term only marginally improves R-square from 14.05% to 14.11%. Though the coefficient is negative (-0.0656) as we expected, it is not statistically significant (t-Stat = -0.79). All other independent variables remain virtually the same compared numbers in previous two model specifications. Taken together, we find industry competition does not change how reputation contributes to improve firm performance. Firms' operation results still highly depend upon conventional factors, such as growth potential, leverage, and market capitalization.

Consistent with earlier studies, we show that financial performance is positively related to prior corporate reputation score. One unit increase in reputation score will generate more than 1.1% extra return on asset in the following year. Larger companies, firms with high growth potential and lower leverage also deliver better subsequent financial outcomes. Industry competition poses a trivial impact on the reputation-to-performance relationships. We then replicate the three models using Tobin’s Q as an alternative performance measure. Results, reported in Panel B of Table 4, remain comparable to the ones in Panel A. Prior reputation presents a favorable effect onto subsequent Tobin’s Q. One unit increase in reputation score will improve subsequent Tobin’s Q by 0.17 unites as shown in Model I and II, and 0.25 units in Model III, respectively. The coefficients of industry intensity and its interaction with reputation score are both insignificant. Similar to the findings in Panel A, R-square remains virtually the same at 0.16 as we add industry competition in the regression specification.

Table 4: Regression Analysis of Reputation-to-Performance

	Model I		Model II		Model III	
	Coefficient	T-Stat	Coefficient	T-Stat	Coefficient	T-Stat
Panel A: Regression Analysis of Reputation to Return on Assets						
Reputation	0.0109**	2.13	0.0109**	2.13	0.0152**	2.08
Log of Market Capitalization	0.0145***	4.59	0.0145***	4.58	0.0146***	4.59
Competition Index			0.0029	0.09	0.4552	0.81
Interaction Term					-0.0657	-0.79
Sales Growth	0.0584**	2.29	0.0584**	2.27	0.0577**	2.23
Leverage	-0.0790***	-3.66	-0.0790***	-3.64	-0.0790***	-3.65
Fama French Industry Dummy	-0.0005**	-2.22	-0.0005**	-2.13	-0.0005**	-2.19
Year Dummy	-0.0029	-0.70	-0.0029	-0.69	-0.0029	-0.68
Intercept	-0.1377***	-3.37	-0.1379***	-3.36	-0.1681***	-2.96
Number of obs		614		614		614
F(6, 607)		17.57		15.04		13.32
Prob > F		0		0		0
R-squared		0.1405		0.1405		0.1411
Root MSE		0.0851		0.0851		0.0851
Panel B: Regression Analysis of Reputation to Tobin’s Q						
Reputation	0.1716***	3.18	0.1714***	3.17	0.2587***	2.72
Log of Market Capitalization	0.0480*	1.93	0.0495*	1.98	0.0518**	2.07
Competition Index			-0.4461	-1.13	8.754	1.13
Interaction Term					-1.3363	-1.17
Sales Growth	0.9270***	2.85	0.9198***	2.83	0.9047***	2.80
Leverage	-1.421***	-5.44	-1.412***	-5.41	-1.412***	-5.43
Fama French Industry Dummy	-0.0057***	-2.59	-0.0065***	-2.89	-0.0068***	-3.07
Year Dummy	-0.0917**	-2.21	-0.0921**	-2.21	-0.0910**	-2.19
Intercept	0.6594	1.41	0.6974	1.50	0.0836	0.12
Number of obs		614		614		614
F(6, 607)		13.07		11.32		10.07
Prob > F		0		0		0
R-squared		0.1632		0.1641		0.1664
Root MSE		0.8264		0.8266		0.8262

Table 4 presents the regression analysis of the reputation-to-performance relationship. Panel A uses ROA to proxy performance while Panel B uses Tobin’s instead. All variables are defined the same way as in Table 2, except the interaction term which is reputation score multiplied by performance. Model I, II and III are specified as in equation (1), (2), and (3) and we cluster errors terms for robustness. All independent variables are lagged by one year to control for endogeneity. ***, ** and * represents the significance level at 10%, 5%, and 1% respectively.

Robustness Check

For robustness check, we re-run the three models, Model I through Model III, by adding one more control variable in Model I, II and III and findings are presented in Table 5. Prior studies have shown that firm performance and reputation could be co-dependent. The causation is not well defined which could cast doubts on our earlier findings. In addition to using lagged independent variable, we add industry median ROA or Tobin’s Q as an additional control in all three regressions. All other variables are defined the same as in earlier discussions. As shown in Panel A and Panel B of Table 5, results are quantitatively compared to the findings presented in Table 4. Reputation still shows a positive effect on future performance. The

coefficients in all three models are very close to the corresponding ones in Table 4. R-square also remains virtually constant in all regressions

Table 5: Regression Analysis of Reputation-to-Performance with Industry Median

	Model I		Model II		Model III	
	Coefficient	T-Stat	Coefficient	T-Stat	Coefficient	T-Stat
Panel A: Regression Analysis of Reputation To Return on Assets						
Industry Median ROA	-0.0083	-0.25	-0.0086	-0.25	-0.0079	-0.23
Reputation	0.0109**	2.13	0.0109**	2.13	0.0152**	2.08
Log of Market Capitalization	0.0144***	4.43	0.0143***	4.42	0.0145***	4.43
Competition Index			0.0038	0.12	0.4528	0.80
Interaction Term					-0.0652	-0.78
Sales Growth	0.0584***	2.28	0.0585***	2.27	0.0578**	2.23
Leverage	-0.0785***	-3.62	-0.0786***	-3.60	-0.0786***	-3.61
Fama French Industry Dummy	-0.0005**	-2.20	-0.0005**	-2.09	-0.0005**	-2.15
Year Dummy	-0.0030	-0.71	-0.0030	-0.71	-0.0029	-0.70
Intercept	-0.1364***	-3.31	-0.1367***	-3.30	-0.1667***	-2.91
Number of obs		614		614		614
F(6, 607)		15.34		13.41		12.1
Prob > F		0		0		0
R-squared		0.1406		0.1406		0.1411
Root MSE		0.0851		0.0852		0.0852
Panel B: Regression Analysis of Tobin's Q						
Industry Median Tobin's Q	0.7702***	7.83	0.7724***	7.86	0.7744***	7.89
Reputation	0.1542***	3.07	0.1539***	3.06	0.2484***	2.94
Log of Market Capitalization	0.0269	1.14	0.0286	1.21	0.0310	1.31
Competition Index			-0.5335	-1.64	9.422	1.42
Interaction Term					-1.446	-1.48
Sales Growth	0.8175***	2.68	0.8086***	2.66	0.7919***	2.62
Leverage	-1.247***	-4.97	-1.236***	-4.92	-1.235***	-4.93
Fama French Industry Dummy	0.0015	0.69	0.0007	0.31	0.0003	0.14
Year Dummy	0.0912**	2.19	0.0913**	2.20	0.0930**	2.23
Intercept	-0.9397*	-1.90	-0.8989*	-1.83	-1.567**	-2.22
Number of obs		614		614		614
F(6, 607)		18.63		16.29		14.48
Prob > F		0		0		0
R-squared		0.2418		0.2432		0.2459
Root MSE		0.7873		0.7872		0.7864

Table 5 presents the regression results using models as specified in Table 4 after controlling for industry average. Panel A uses ROA to measure financial performance while Panel B uses Tobin's Q. Industry average ROA or Tobin's Q is computed based upon firms within the same Fama-French 48 industry specification in each fiscal year. All other variables and model specifications remain the same as in Table 4. ***, ** and * represents the significance level at 10%, 5%, and 1% respectively.

Performance-to-Reputation

Next, we examine how industry intensity interacts with the performance-to-reputation relationship. We first run the base model, Model IV, following Flanagan et al (2013); then we add the industry intensity effect in Model V, and include the interaction between competitiveness and reputation score in Model VI, respectively. We specify our Model IV – VI in the following:

$$Reputation_{i,t} = \alpha + \beta_1 \times ROA_{i,t-1} + \beta_2 \times Size_{i,t-1} + \beta_3 \times Sales\ Growth_{i,t-1} + \beta_4 \times Leverage_{i,t-1} + \beta_5 \times Industry\ Dummy_{i,t-1} + \beta_6 \times Year\ Dummy_{i,t-1} + \varepsilon_{i,t} \quad (4)$$

$$Reputation_{i,t} = \alpha + \beta_1 \times ROA_{i,t-1} + \beta_2 \times Industry\ Intensity_{i,t-1} + \beta_3 \times Size_{i,t-1} + \beta_4 \times Sales\ Growth_{i,t-1} + \beta_5 \times Leverage_{i,t-1} + \beta_6 \times Industry\ Dummy_{i,t-1} + \beta_7 \times Year\ Dummy_{i,t-1} + \varepsilon_{i,t} \quad (5)$$

$$\begin{aligned}
\text{Reputation}_{i,t} = & \alpha + \beta_1 \times \text{ROA}_{i,t-1} + \beta_2 \times \text{Industry Intensity}_{i,t-1} + \beta_3 \times \text{Industry Intensity}_{t-1} \times \\
& \text{ROA}_{t-1} + \beta_4 \times \text{Size}_{i,t-1} + \beta_5 \times \text{Sales Growth}_{i,t-1} + \beta_6 \times \text{Leverage}_{i,t-1} + \beta_7 \times \\
& \text{Industry Dummy}_{i,t-1} + \beta_8 \times \text{Year Dummy}_{i,t-1} + \varepsilon_{i,t}
\end{aligned} \tag{6}$$

We, again, lag all independent variables for one year to control for endogeneity. Regression results are reported in Table 6. Panel A uses ROA to measure performance while Panel B employs Tobin's Q instead. Consistent with Brown and Perry (1994) and Flanagan et al (2010), reputation score is highly correlated with prior financial performance. 1% increase in ROA improves the next year's reputation score by 0.0246 and the coefficient is significant at the 1% level (t-stat = 5.73) as shown in Table 6. Firm size is also significant. Large companies are more reputable given more name recognition and capital supply. As we add industry intensity as an additional independent variable in Model V, R-square remains unchanged at 20.26%. The coefficient of industry intensity is not significant even though the positive sign is in line with our expectation that high market concentration is related to higher profit margin. Other independent variables are close to the ones in Model V. It appears that competition itself does not explain any variation of reputation score. Finally, Model VI adds the interaction term between ROA and industry competition.

While all other variables remain comparable as in Model IV and V, industry intensity becomes highly significant with a coefficient of -1.29 and t-statistics of 2.00, which results indicate that as the Herfindahl Index decreases by one unit, reputation score will improve by 1.06 units in the following year. As we discussed earlier, competition could function as an additional channel of monitoring. As competition intensifies, firms are forced to perform regardless of other firm characteristics. Higher competition is like to support better company performance if everything else holds constant. Such institutional feature assists outsiders, who do not have the access to the complete information set, to evaluate company reputation. Moreover, as shown in Panel A of Table 6, the interaction term is highly significant with a coefficient of 17.32 and t-statistics of 2.27. It highlights that influence of firm performance on reputation varies significantly according to the level of industry intensity.

For non-competitive sectors, ROA is still critical in determining subsequent reputation. However, for competitive sectors, the impact of ROA on reputation is moderated. Two reasons may explain such difference. First, competitive sectors general tend to have lower profitability, which may make ROA less reliable for any assessment. Second, competition also increases information transparency, which makes it easier for outsiders to assess reputation through other channels and become less reliant on financial outcomes. Such effect matches with the negative coefficient of industry intensity in the model. For robustness check, we re-run three models using Tobin's Q instead of ROA and results are summarized in Panel B of Table 6. Even though both coefficients and statistical power become weaker, our findings are still consistent with the ones based on ROA. In Model VI, the reputation effect is diluted and it only poses positive influence as competition is reduced. Taken together, our regression results show that performance-to-reputation relationships do vary in accordance with competition. Companies operating in high competition sectors tend to have better reputation. Their financial outcomes are less important in explaining future reputation score. On the other hand, firms operating in concentrated business still rely on their operational results when their reputation is assessed.

Table 6: Regression Analysis of Performance-to-Reputation

	Model IV		Model V		Model VI	
	Coefficient	T-Stat	Coefficient	T-Stat	Coefficient	T-Stat
Panel A: Return on Assets and Reputation						
Reputation	2.460***	5.73	2.463***	5.73	1.546***	2.77
Log of Market Capitalization	0.1761***	9.01	0.1759***	8.97	0.1751***	8.91
Competition Index			0.0592	0.24	-1.056**	-2.00
Interaction Term					17.322**	2.27
Sales Growth	-0.0251	-0.14	-0.0248***	-0.13	-0.0204	-0.11
Leverage	0.0103	0.05	0.0094***	0.05	0.0214 *	0.11
Fama French Industry Dummy	0.0032*	1.70	0.0033*	1.7	0.0032	1.60
Year Dummy	-0.0020	-0.07	-0.0020	-0.07	-0.0019	-0.07
Intercept	4.947***	23.06	4.942***	22.91	5.012***	22.94
Number of obs		634		634		634
F(6, 607)		27.53		23.56		22.52
Prob > F		0		0		0
R-squared		0.2026		0.2026		0.2065
Root MSE		0.60983		0.61031		0.60929
Panel B: Tobin's Q and Reputation						
Reputation	0.0985***	4.74	0.0989***	4.72	0.0501*	1.66
Log of Market Capitalization	0.1780***	8.97	0.1776***	8.91	0.1758***	8.66
Competition Index			0.1047	0.39	-1.916	-1.63
Interaction Term					1.142*	1.72
Sales Growth	-0.0765	-0.38	-0.0764	-0.38	-0.0600	-0.3
Leverage	-0.1073	-0.54	-0.1087	-0.55	-0.1023	-0.52
Fama French Industry Dummy	0.0028	1.44	0.0029	1.49	0.0029	1.48
Year Dummy	0.0010	0.03	0.0011	0.04	0.0000	0.00
Intercept	4.937***	23.13	4.928***	22.96	5.030***	22.02
Number of obs		634		634		634
F(6, 607)		26.88		23.01		21.66
Prob > F		0		0		0
R-squared		0.1935		0.1936		0.1974
Root MSE		0.6133		0.6137		0.6128

Table 6 presents the results of regression analysis of performance-to-reputation relationship. Panel A uses ROA to proxy performance and Panel B employs Tobin's Q. All other variables are defined in the same way as in Table 4 and 5. Model IV, V and VI are specified as in equation (4)-(6). ***, ** and * represents the significance level at 10%, 5%, and 1% respectively.

CONCLUDING COMMENTS

In the last few decades, reputation has become increasingly critical in the decision-making process for modern corporations. Not only does it reflect a corporation's public image, it also helps boost profitability and enhance shareholders value. Prior research has confirmed a virtuous relationship between financial performance and corporate reputation. As stated in these studies, a good reputation leads to strong financial outcomes (Gupta, 2002, Rose and Thomsen, 2004) meanwhile, better financial performance enhances firms' subsequent reputation (Koch and Cebula, 1994, Flanagan et al, 2013). This bilateral relationship is sustainable over time (Roberts and Dowling, 2002). However, reputation is difficult to measure given its implicit nature and, more importantly, there is the lack of universal consensus of reputation proxy. Walker (2010) posits that reputation is an aggregated concept among various external constituents. Operationalizing reputation is challenged by how to incorporate different views from various outsiders who tend to focus only on a subset of reputation determinants.

Practically, most existing reputation surveys only contain certain aspects of reputation. The most commonly-used measure is Fortune's Most Admired Company (FMAC) list, which has eight different criteria and is based upon a variety of experts' opinions. Using FMAC, the virtuous relationship between reputation and financial outcomes has been verified by multiple studies. Nevertheless, many confounding factors are largely unidentified in prior research. In the present study, we re-examine the recursive relationship between reputation and firm financial performance along with industry intensity. Similar to earlier findings, such as McGuire et al (1990), we show a positive correlation between prior reputation and financial performance. We find that industry intensity does *not* change this dynamic. R-squares virtually

unchanged (R-square=14%) when we add the industry competition proxy, the Herfindahl Index, into our regressions. The coefficient of firm reputation remains at 0.011 in all three specifications, which indicates that one unit increase in reputation score can improve future ROA by 1.1% regardless of competition status. On the other hand, we find that previous financial outcomes affect corporate reputation differently given different industry intensity. In non-competitive sectors, ROA still plays a dominant role in determining firms' reputations. Such effect, however, is moderated in competitive sectors. More competitive sectors generally have firms with better reputation, and prior financial performance becomes less important in the reputation assessment. As to non-competitive sectors, ROA or Tobin's Q is still critical in subsequent reputation assessment. We argue that competition helps to improve a firm's reputation as a supplementary monitoring channel and reduces the explaining power of prior financial outcomes on future reputation scores. Our results advance our understanding of the dynamic between reputation and performance.

Our results, though, should be interpreted with caution. Fryxell and Wang (1994) explain the limitation of using FMAC as a measure of reputation. They argue that FMAC relies on financial metrics and is less representative of the view of other stakeholders. Also, it is possible that the link between financial performance and reputation is driven by unidentified variables. Moreover, endogeneity problem also casts doubts on our findings. A better statistical approach with valid instrument variable could strengthen our findings. In reputation research, more work needs to address these issues and to refine the causation between reputation and performance as well as their interactions with other confounding factors. These efforts will help practitioners greatly in their decision-making process.

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