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Firm reputation and investment decisions: The contingency role of securities analysts' recommendations

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ABSTRACT

Moving beyond resource-based consequences of a firm's reputation, we develop a behavioral perspective on the impact of corporate reputation. Although there has been extensive discussion in previous studies of the benefits of reputation in terms of gaining resource advantages, we apply theory on self-regulatory focus to suggest that highly reputable firms may tend to have a prevention focus rather than a promotion focus in their investment strategies. This tendency will lead the firm to opt for low-risk investments rather than high-risk investments. Furthermore, we develop a contingency model and argue that the main effect of reputation on the investment decisions of the firm is further strengthened by the negative recommendations of securities analysts. We find support for our hypotheses. In doing so, we address emerging theories about the potential negative consequences of a firm's reputation and provide important insights for our theoretical understanding of the behavior of highly reputable firms.

The value of having a strong reputation has been well addressed and emphasized in the literature (Dierickx and Cool, 1989; Schwaiger, 2004; Weigelt and Camerer, 1988). Firm reputation has been argued to be an asset that is valuable, rare, and difficult to imitate, thereby giving those who possess it particular competitive advantages in the marketplace (Roberts and Dowling, 2002). Reputable firms achieve superior financial returns (Barney, 1991; Grant, 1991), have better access to capital markets (Beatty and Ritter, 1986), are able to attract higher-caliber employees (Fombrun, 1996), and can access potential investors more effectively (Milgrom and Roberts, 1986). Nevertheless, whilst most studies on firm reputation have focused on the benefits that reputation confers in terms of resources, its effects on behavioral outcomes have been overlooked. In this study, we address this shortcoming and draw upon expectancy violations theory and regulatory focus theory to uncover the relationship between a firm's reputation and its investment decisions. By doing so, our study provides important insights for research and practice by demonstrating that behavioral consequences may help in understanding the potential liabilities of a firm's reputation over time. In this way, we provide at least two important contributions to earlier research.

First, we move beyond the resource-based perspective on firm reputation (Milgrom and Roberts, 1986; Roberts and Dowling, 2002) by examining the behavioral consequences of firm reputation. Our behavioral perspective enriches emerging debates about the potential liabilities of having a high reputation (Mishina et al., 2010; Rhee and Haunschild, 2006) and challenges the notion that reputation may lead to a competitive advantage over time (Raithel and Schwaiger, 2014). We

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draw on research on expectancy violations theory and regulatory focus theory to explore how a firm's reputation — as a risk-averting mechanism for the firm — may affect its strategic choices. It has been argued that reputation creates expectations among stakeholders that firms will continue to act in the same way and to the same standard as their reputation has been built upon (Pfarrer et al., 2010; Rhee and Haunschild, 2006). Firms that do not meet these expectations are punished more severely than their non-reputable competitors (Rhee and Haunschild, 2006). As such, reputable firms are expected to avoid violating expectations in this way. Informed by self-regulatory focus theory, we explain how and why a firm's reputation affects the tendency of organizations to become risk-averse. Any social entity regulates its behavior and strategic choices by opting either for a promotion-focus that is concerned with future-oriented growth and advancement or a prevention-focus that is more concentrated on safer choices which help maintain the status quo (Crowe and Higgins, 1997). We argue that reputable firms are more likely to adopt a prevention focus when seeking to meet external expectations and to engage in low-risk investments rather than high-risk investments.

Second, we examine the contingency role of recommendations made by securities analysts – as an external source of performance feedback – in shaping the relationship between a firm's reputation and its investment decisions. The reputation of a firm indicates how it is perceived by stakeholders (Fombrun and Shanley, 1990). With this comes a set of investment decisions that the reputable firm feels would prevent it from violating external expectations. However, while financial performance is a general indicator, it is hard for firms to get a sense of when they have either failed to fulfill external expectations or are at risk of doing so (Rhee and Valdez, 2009). One source of such information is securities analysts and their recommendations. A recurring theme in institutional theory is that pressures from external institutions such as securities analysts prompt firms to conform to the norms and expectations of those institutions (Greenwood and Hinings, 1988). Despite its relevance, the behavioral interplay between firms' reputation and analysts' recommendations has not yet been investigated. In this study, we argue that negative recommendations by analysts signal to reputable firms that stakeholder expectations are being violated. Because reputable firms are prone to prevention foci, these cues exacerbate their tendency to pursue low-risk investments.

In this study, we test our hypotheses using a 128-firm sample over a period of four years, for a total of 512 firm-year observations. Our multi-source panel data set consists of both survey data on reputation and objective data on financial aspects. Consistent with our theoretical framework and argumentations, we find that a higher level of reputation encourages a firm to invest in low-risk initiatives, and discourages them from investing in high-risk strategic initiatives. Finally, when we investigate the moderating effect of securities analysts' recommendations, we find that receiving negative recommendations from securities analysts reinforces the main effect of firm reputation, namely that it makes firms more risk-averse in their investment decisions.

Theory and hypotheses

Firm reputation as a double-edged sword: meeting and violating expectations

A firm's reputation — perceived by the firm's stakeholders — is a socially constructed organizational phenomenon that is rooted in its past performance and behavior (Lange et al., 2011). The essence of the reputation construct is reflected in Fombrun's (1996) definition, where he defines firm reputation as the perceptual representation of the firm's past actions and future prospects that determines the general appeal of the firm to all of its constituencies when compared to other similar firms. In most of the literature on firm reputation the focus has been on the fact that reputation is an invaluable and difficult to imitate asset that endows the firm with various benefits not enjoyed by its less reputable competitors (Boyd et al., 2010). Scholars have argued that firms with a strong reputation may enjoy a number of advantages, both financial and non-financial (Saxton and Dollinger, 2004; Turban and Cable, 2003). However, a careful review of the literature on firm reputation leads to the realization that an over-emphasis on the positive resource-based outcomes of reputation has somewhat diverted attention from its possible negative behavioral consequences for the organization over time (Highhouse et al., 2009).

To that end, investigating the underlying psychological meaning of reputation should help to shed some light on the possible burdens of being reputable. As reputation is shaped in the minds of stakeholders, it involves the psychological processes of perception and interpretation (Love and Kraatz, 2009). Reputation contains a unique informational aspect that compensates for the informational asymmetry and uncertainty that stakeholders will naturally experience before initiating their dealings with a certain organization (Fombrun and Shanley, 1990). In that sense, reputation acts as a type of promise to stakeholders, reassuring them that, based on past performance, the firm will be capable of delivering the quality and outcomes they expect in the future and that the firm's future behavior will be predictable (Lange et al., 2011; Stiglitz, 2000).

At the same time, however, the reputable firm could lose all the benefits derived from its reputation if organizational errors are revealed or the firm fails to meet the expectations of its stakeholders (Rhee and Haunschild, 2006). According to expectancy violations theory, when a violation of the expected behavior or outcome occurs, the violation will arouse and distract the attention of the stakeholders (Burgoon, 1993). The violation will be arousing and distracting as it heightens and reallocates the attention of the stakeholders to the characteristics of the violator and the meaning of the violation act (Burgoon and Hubbard, 2005). According to expectancy violations theory, when there is a violation of expected behavior or outcome, this will draw the attention of stakeholders to the violator, causing them to look more closely at the characteristics of the violator and the nature of the violation itself. However, instead of seeking to understand the reasons why the violation has occurred, stakeholders are more likely to react negatively, calling into question the character of the violator and imposing

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