# A Conceptual Model of the Relationship between Corporate Reputation and Financial Performance in the Indonesian Banking Industry

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***Abstract***

This paper set out to develop a conceptual model for testing some relationships between corporate reputation and financial performance in Indonesian banking industry. The relationship between corporate reputation and financial performance are investigated in three ways: the influence of prior financial performance on the current corporate reputation, the influence of current corporate reputation on current financial performance, and the mediating effect of corporate reputation on the relationship between prior financial performance and current financial performance. Literature review, conceptual model, hypotheses development and research methodology are discussed. Practicing this paper instantly would provide information to Indonesian banking companies that will allow them to enlarge their knowledge of this relationship.
***Keywords:*** Corporate Reputation, Financial Performance, Indonesian Banking Industry, Conceptual Model.

## 1. Introduction

In the area strategic management literature, corporate reputation is essentially important. The importance of corporate reputation is as one of intangible assets for a corporation (Roberts & Dowling, 2002; Rumelt, 1987; Weigelt & Camerer, 1988). Anexcellent corporate reputation can lead to many strategic benefits to a corporation, such as attracting investors (Srivastava *et al.*, 1997), customers (Fombrun, 1996), and applicants (Fombrun, 1996; Turban & Greening, 1997).It is also lowering firm costs (Deephouse, 2000; Fombrun, 1996), customer retention (Fombrun, 1996; Fombrun & Pan, 2006), increasing profitability (Roberts & Dowling, 2002), enabling companies to charge premium prices (Deephouse, 2000; Fombrun & Shanley, 1990;Rindova *et al.*, 2005), creating competitive barriers (Deephouse, 2000; Fombrun, 1996; Milgrom & Roberts, 1982), and fostering and strengthening competitive advantages (Barney, 1991; Roberts & Dowling, 1997).

Nevertheless, while the important of corporate reputation and its linking to financial performance appears to be important in the banking industry/sector (Sabate & Puente, 2003b). There were two types of relationships have been identified when defining the relationship between corporate reputation and financial performance (Sabate & Puente, 2003a). It involves answering two questions: 1) the characterization of the relationship sign as negative or positive, and 2) the direction of causality, whether financial performance has an influence corporate reputation or whether corporate reputation affects financial performance. Some contradictory results have been reached on these two questions (Sabate & Puente, 2003a).Therefore, this paper set out to review the literature of the relationship between corporate reputation and financial performance, develop a conceptual model for testing some relationships between corporate reputation and financial performance in Indonesian Banking Industry, hypotheses development and research methodology.The rest of this paper is organized as follows: Section 2 reviews related literature on the relationship between corporate reputation and financial performance, Section 3 discusses the conceptual model, and the hypotheses development is given in the Section 4. Section 5 describes the methodology used and Section 6 is the conclusion of this paper.

## 2. Literature Review

A considerable survey of literature on the empirical analysis of the relationship between corporate reputation and financial performance has been published on Corporate Reputation Review (Sabate & Puente, 2003a). This study has been reviewed numerous empirical studies on the relationship between corporate reputation and financial performance. The study has divided this review into four sections. Firstly, the study bringstogether individuals studies analyzing the presence or absence of a relationship between corporate reputation and financial performance without assumption regarding the nature of the relationship. There were two studies in this first section (Sabate & Puente, 2003a). There was a positive relationship between corporate reputation and financial performance (Preston & Sapienza, 1990).However, Schultz, Mouritsen, Gabrielsen and Ramussen (2000) found no evidence of this relationship. This situation unavoidably leads them to dissimilar interpretations.

Secondly, survey those studies which analyze the effect of financial performanceon corporate reputation construction. There were four studies in this second section (Fombrun & Shanley, 1990; Hammond & Slocum, 1996; Riahi-Belkaoui & Pavlik, 1991; Sobol&Farelly, 1998). Sobol and Farelly (1998) found that the possible affect of financial performance on the corporate reputation construction. Their results showed that the relevance of financial performance different according to the dissimilar attributes corporate reputation survey and different from industry to industry. Fombrun and Shanley (1990) found the most significant signals of corporate reputation were profitability and risk during the prior period and market valuation. Some non financial variables: property concentration, charitable works, size, dividends payout corresponding to the prior financial year; were shown less significant. Riahi-Belkaoui and Pavlik (1991) found some significant variables concerning corporate reputation development corresponding to different measures of asset management such as: the size of assets as an indicator of a firm, asset rotation and profit margin as a quality measure of the efficiency of resource usage, and the Tobin's q as a signal of agency cost.However, Hammond and Slocum (1996) demonstrated a negative influence of standard deviation of the market return of the company on corporate reputation. These studies which analyze the affect of financial performance on corporate reputation lead to two basic problems, one methodological and one theoretical (Sabate & Puente, 2003a).

Thirdly, survey those studies which analyze the influence of corporate reputation on financial performance. There were eight studies in this third section (Arbelo & Perez, 2001; Black *et al.*, 2000; Corderio & Sambharya, 1997; Deephouse, 1997; Jones *et al.*, 2000; Roberts & Dowling, 1997; Srivastava *et al.*, 1997; Vergin & Qoronfleq, 1999). All those studies demonstrated a positive influence of corporate reputation on financial performance (Sabate & Puente, 2003a). Once again, Sabate and Puente(2003a) found the lack of theoretical framework supporting this relationship. This absence of theoretical framework leads to wonder whether there really a two way relationship between corporate reputation and financial performance.

Finally, survey those studies which analyze a two-way relationship, both direction of relationship between corporate reputation and financial performance. There were four studies in this fourth section and using sample from multiple industries (Chung *et al.*, 1999; Dunbar & Schwalbach, 1988; Dunbar & Schwalbach, 2000; McGuire *et al.*, 1990). McGuire, Schneeweis and Branch (1990) found a negative relationship between corporate reputation and the quotient of debt divided by assets and returns on assets, while a positive relationship between corporate reputation and return on assets. Also, Dunbar and Schwalbach (1988, 2000) found the negative influence of financial performance on corporate reputation when financial performance defined by accounting measures, while there is a positive influence of financial performance on corporate reputation when financial performance defined by market measurements. Chung, Schneeweis and Eneroth (1999) found that prior economic events i.e. changes in company's market value, influence the perceptions of corporate reputation, while changes in company's market value disproved signal future financial performance.

There were a variety of results regarding the relationship between corporate reputation and financial performance. There were two main restrictions were encountered in the survey of literature(Sabate& Puente, 2003a). First is the need for a theoretical framework that would sort out and establish consistency among the studies undertaken. This leaves a conceptual gap. Second is the need a methodology which allowsinvestigating two-way relationship.Beside the conceptual gap, however, there is no research on the relationship for Indonesia companies. This leaves a contextual gap. Therefore, this would require an investigation on the relationship between corporate reputation and financial performancethat would be suitable for Indonesia companies, especially for companies in the Indonesian banking industry.

## 3. Conceptual Model

The general objective of this paper is to investigate therelationship between corporate reputation and financial performance for Indonesia companies.The general objective is further broken down into three specific objectives. This paper has to set out a conceptual model to investigate: (1) the influence of prior financial performance on current corporate reputation, (2) the influence of current corporate reputation on current financial performance, (3) the mediating effect of corporate reputation on the relationship between prior financial performance and current financial performance.

The first specific objective of this paper is to investigate the influence of prior financial performance on current corporate reputation.The model in Figure 1 depicts all the relationships between corporate reputation and financial performance. According to this model,prior financial performance represents the signals of corporate reputation (an arrow from prior financial performance to current corporate reputation). It can be explained that corporate reputation are not publish periodically in Indonesia, hence public could only assess corporate reputation based on the asymmetric information.The signal takes root in the idea of asymmetric information (Connelly *et al.*, 2011; Spence, 1973). Empirical studies on signaling indicate that statistically significant of current corporate reputation (Basdeo *et al.*, 2006; Fombrun & Shanley, 1990; Riahi-Belkaoui & Pavlik, 1991; Sobol & Farelly, 1998).

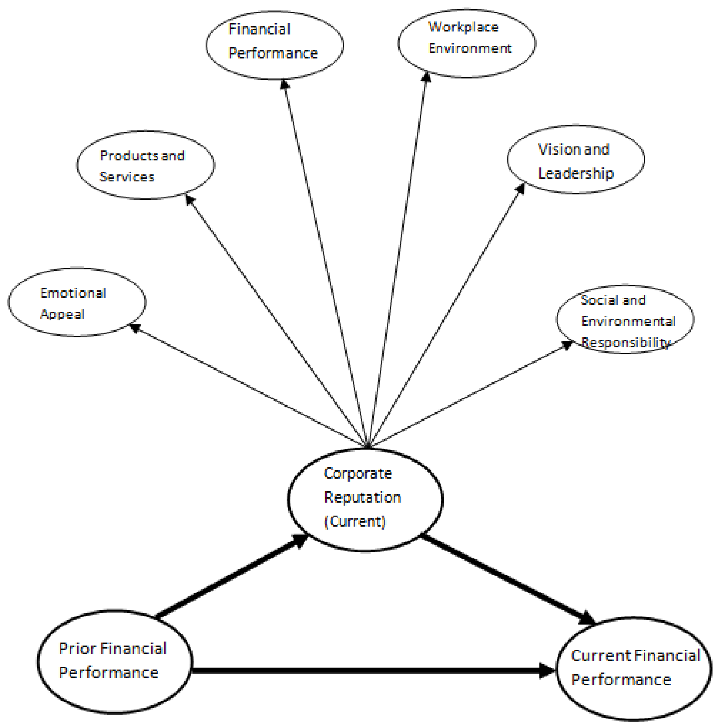


**Figure 1: The Conceptual Model**

*Source:* Adapted from 'Reputation Quotient' (Fombrun *et al.*, 2000) and the 'Model of reputation-financial performance dynamics' (Roberts & Dowling, 2002).

The second specific objective is to investigate the influence of current corporate reputation on current financial performance. Figure 1 depicts the instrumental aspect of stakeholder theory (an arrow from current corporate reputation to current financial performance). The instrumental aspect of the stakeholder theory is to identify the connection or lack of connection between the stakeholder management (corporate reputation) and the achievement of the traditional corporate objectives (current financial performance) (Donaldson & Preston, 1995). There were some studies on corporate reputation that could systematically be applied to the instrumental aspect of stakeholder theory to link it to corporate reputation (Cable & Graham, 2000; Cornell & Saphiro, 1987; Deephouse, 2000; Preston *et al.*, 1991; Roberts & Dowling, 2002).

The third specific objective is to investigate the mediating effect of corporate reputation on the relationship between prior financial performances on current financial performance. All the three bold arrows in Figure 1 depict the mediating effect of corporate reputation on the relationship between prior financial performances on current financial performance (Baron & Kenny, 1986; Roberts & Dowling, 2002).The full or partial mediation is supported if all the three bold arrows have significant correlations and the arrow from prior financial performance to current financial performance is reduced when current corporate reputation is included as an additional predictor (Cohen & Cohen, 1983).

To accomplish all of these three objectives, all the three bold arrows in Figure 1 are subjected to empirical tests.

## 4. Hypotheses Development

### *4.1 Hypotheses Developed for the Influence of Prior Financial Performance on Current Corporate Reputation*

This hypothesis is developed to answer the first specific objective. Prior financial performance is one of the most important antecedents of corporate reputation (Roberts & Dowling, 2002). Many researchers have supported a positive significant of a company's prior financial performance on corporate reputation (Basdeo *et al.*, 2006; Fombrun & Shanley, 1990; Riahi-Belkaoui & Pavlik, 1991; Sobol & Farrelly, 1988). This hypothesis is suggested that prior financial performance will influence current corporate reputation, andthe following research hypothesis is proposed:

H1: Prior financial performance will have a positive influence on corporate reputation.

### *4.2 Hypothesis Developed for the Influence of Current Corporate Reputation on Current Financial Performance*

This hypothesis is developed to answer the second specific objective. A variety of potential benefits of superior corporate reputations provide the rationale for a cross-sectional relationship between current corporate reputation and current financial performance (Fombrun, 1996, Podolny, 1993). The results from the empirical studies on the influence of corporate reputation on financial performance are apparently more consistent as the positive results have been validated (Sabate & Puente, 2003). Many researchers have supported the positive significance of current corporate reputation on current financial performance (Deephouse, 1997; Corderio & Sambharya, 1997; Jones *et al.*, 2000; Roberts & Dowling, 1997; Srivastava *et al.*, 1997). Therefore, the following research hypothesis is proposed:
H2: Current corporate reputation will have a positive influence on current financial performance.

### *4.3 Hypothesis Developed for Testing the Mediating Effect of Corporate Reputation on the Relationship between Prior and Current Financial Performance*

This hypothesis is developed to answer the third specific objective. The reputation-financial performance dynamics model argues that prior financial performance will influence current corporate reputation (Roberts & Dowling, 2002). This argument is reasonable since several studies have validated the positive influence of a firm's prior financial performance on the current corporate reputation (Basdeo *et al.*, 2006; Fombrun & Shanley, 1990; Riahi-Belkaoui & Pavlik, 1991; Sobol & Farrelly, 1988). While many studies have supported the positive influence of current corporate reputation on current financial performance (Deephouse, 1997; Corderio & Sambharya, 1997; Jones *et al.*, 2000; Roberts & Dowling, 1997; Srivastava *et al.*, 1997). Therefore, by taking advantage of the results from H1 and H2, the following research hypothesis is offered for testing the mediating effect of corporate reputation on the relationship between prior financial performance and current financial performance:

H3: Corporate reputation mediates the relationship between prior financial performance and current financial performance.

## 5. Methodology

To examinethe relationship between corporate reputation and financial performance as stated in the three specific research objectives, a two stage process has developed from the literature. The existing literature therefore provides a clear guidance of both the processes and the tools necessary to complete the process.
Table 1 summarizes the research plan and outlines the goals at each stage of the research.

**Table 1: Overview of Research Plan**

| Research Stage | Research Objectives | Analysis | Sample |
|---|---|---|---|
| Confirmatory Quantitative Research | Confirmatory the factors of corporate reputation and assess its dimensionality<br><br>Assess the dimensionality of prior financial performance and current financial performance indicators | Confirmatory Factor Analysis (CFA)<br><br>Confirmatory Factor Analysis (CFA) | Indonesian Banking stakeholders in Jakarta and surrounding areas who are at least 25 years of age |
| Structural Model | The influence of prior financial performance on current corporate reputation<br><br>The influence of current corporate reputation on current financial performance<br><br>The mediating effect of corporate reputation on the relationship between prior and current financial performance | Structural Equation Modeling (SEM)<br><br>Structural Equation Modeling (SEM)<br><br>Structural Equation Modeling (SEM) | Indonesian Banking stakeholders in Jakarta and surrounding areas who are at least 25 years of age |

Stage 1 is confirmatory quantitative research. In this stage, all of the factors of corporate reputation should be confirmed using confirmatory factor analysis(CFA) and should be assessed its dimensionality. This paper uses six dimensions/factors of Reputation Quotient (RQ) that introduced by Fombrun *et al.* (2000)as a measure of corporate reputation. The Reputation Quotient (RQ) develops a company's rating among competitors based on 20 (twenty) attributes comprising into six dimensions/factors of corporate reputation: emotional appeal, products and services, vision and leadership, financial performance, workplace environment, and social and environmental responsibility (Fombrun *et al.*, 2000). The Reputation Quotient (RQ) has been tested among countries in the United States, Europe, and Australia (Gardberg, 2006). The result showed that the six factors of RQ have been accepted as dimensions/factors of corporate reputation in those countries (Gardberg, 2006). Therefore, all the six factors would be assessed its single and multi-dimensionality using confirmatory factor analysis (CFA).
Also, stage 1 assesses the dimensionality of financial performance: prior financial performance and current financial performance. Financial performance is defined as a subjective measure of how well a firm can use assets from its primary mode of business and generate revenues (Moyer *et al.*, 2009). Gilley and Rasheed (2000) and Martinez-Sanchez *et al.*(2007) have been conducted that proposed a list of financial performance measures using the term of accounting measures and overall financial performance. They have measured financial performance with the following items: return on assets, return on sales, total profit, and overall financial performance (Gilley & Rasheed, 2000; Martinez-Sanchez *et al.*, 2007). Therefore, each of the prior financial performance and current financial performanceshould be comprised of those 4 (four) items, and each ofthe prior and the current financial performanceshould be assessed itsdimensionality using confirmatory factor analysis (CFA).

Stage 2 is structural model tests. In this stage, three structural models should be tested here. The structural models are: the influence of prior financial performanceon current corporate reputation, the influence of current corporate reputation oncurrent financial performance, and the mediating effect of corporate reputation on the relationship between prior financial performance and current financial performance. These structural models will be tested using structural equation modeling (SEM).

This research is confined to one industry only, the banking industry. The approach to focus on the banking industry is undertaken to address the gaps highlighted in the studies by Sabate and Puente (2003a, 2003b). Therefore, seven large banks rated 'very good' are selected from the Indonesia banking industry (Jakarta-Post, 2011). The bank names are Bank Central Asia, Bank CIMB Niaga, Bank Danamon, Bank Mandiri, Bank Negara Indonesia, Bank Panin, and Bank Rakyat Indonesia (Jakarta-Post, 2011).

The population in this research is Indonesian individuals who are identified as banking stakeholders. The sample is at least 300 Indonesianindividualsin Jakarta and surrounding areas who are at least 25 years of age and identified as banking stakeholders in at least one of those seven banks. The authors decided to obtain a minimum of 300 respondents is in line with suggestion made by Hair *et al.* (2010). The non-probability sampling technique was adopted for this research because the population of the study was undocumented (Malhotra, 1999). This sampling method, a combination of two types sampling techniques: the purposive and the quota, was undertaken since the local database for the Indonesian population who were identified as stakeholders in the banking industry has not yet been documented based on their stakeholder groups (Castillo, 2009; Dowling, 1994; Ferber, 1977).

## 6. Conclusion

In the Eastern societies, as well as Indonesia, where is no periodic publications of corporate reputation ratings and little if any academic literature within the Indonesian context regarding this topic, knowing the relationship between corporate reputation and financial performance are immense by both practitioners and academics. Without knowing the relationship, it is difficult to move forward in this field of study and make meaningful contributionspracticallyandtheoretically. This paper has set out to propose a conceptual model for testingthe relationship between corporate reputation and financial performance in the Indonesian banking industry.This paper proposesto use the existing Reputation Quotient (RQ) for measure corporate reputation (Fombrun *et al.*, 2000; Gardberg, 2006). This paper alsoproposes to tests the relationship between corporate reputation and financial performance in three sections: 1) the influence of prior financial performance on the current corporate reputation, 2) the influence of current corporate reputation on current financial performance, and 3) the mediating effect of corporate reputation on the relationship between prior financial performance and current financial performance. Also, this paper has discussed literature review on the relationship between corporate reputation and financial performance, the conceptual model of the relationship, hypotheses development, and the methodology. By knowing a clear explanation on the relationship between corporate reputation and financial performance in their industry,it would provide information to Indonesian banking companies on how to make them better able to discharge their duties.

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