© Academy of Management Journal
1990, Vol. 33, No. 2, 233–258.

WHAT'S IN A NAME? REPUTATION BUILDING AND CORPORATE STRATEGY

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Firms compete for reputational status in institutional fields. Managers attempt to influence other stakeholders' assessments by signaling firms' salient advantages. Stakeholders gauge firms' relative merits by interpreting ambiguous informational signals from the firms, the media, and other monitors. The results of an empirical study of 292 large U.S. firms supported the general hypothesis that publics construct reputations on the basis of information about firms' relative structural positions within organizational fields, specifically using market and accounting signals indicating performance, institutional signals indicating conformity to social norms, and strategy signals indicating strategic postures. Understanding the informational medium from which publics construct reputations helps explain sources of mobility barriers within industries that originate in external perceptions.

Corporate audiences routinely rely on the reputations of firms in making investment decisions, career decisions, and product choices (Dowling, 1986). Reputations signal publics about how a firm's products, jobs, strategies, and prospects compare to those of competing firms. Favorable reputations can therefore generate excess returns for firms by inhibiting the mobility of rivals in an industry (Caves & Porter, 1977; Wilson, 1985).

Reputations may have other potentially favorable consequences. By signaling consumers about product quality, favorable reputations may enable firms to charge premium prices (Klein & Leffler, 1981; Milgrom & Roberts, 1986b), attract better applicants (Stigler, 1962), enhance their access to capital markets (Beatty & Ritter, 1986), and attract investors (Milgrom & Roberts, 1986a). Ultimately, reputational orderings crystallize the statuses of firms within an industrial social system (Shrum & Wuthnow, 1988) and thereby constitute an important venue for reconciling economic and sociological contributions to the study of industrial stratification (Fombrun, 1986).

We have greatly benefited from the encouragement and helpful suggestions of colleagues, especially Wayne Baker, Jane Dutton, Mark Mizruchi, Stefan Wally, and this journal's anonymous reviewers. Many thanks. This research was partially supported by a Gitlin Fellowship and the Tenneco Fund Program at the Leonard Stern School of Business, New York University, and by a Faculty Fellowship from the University of Chicago's Graduate School of Business.

Few empirical investigations have sought to understand the factors that influence corporate reputations. In a study of the *Fortune* 500, McGuire, Sundgren, and Schneeweis (1988) found that prior return on assets was highly correlated with a firm's reputation for social responsibility, which suggests that economic performance serves an important signaling function when publics construct reputational rankings of firms.

Yet economic performance is not the only basis on which to assess firms. Firms serve multiple stakeholders, each of which applies distinct criteria in evaluating corporate performance (Freeman, 1984). A theoretical articulation of reputation as a construct should therefore anticipate the multiple economic and noneconomic criteria different constituents are likely to apply in assessing firms.

This article interprets reputations as the outcome of a competitive process in which firms signal their key characteristics to constituents to maximize their social status (Spence, 1974). Because of informational asymmetries in the market for reputational status, each of a firm's multiple publics selectively attends to different informational cues, or signals, in judging its effectiveness. Following Spence, we defined signals as "alterable observable attributes" (1974: 107).

Although many signals broadcast to constituents are under firms' control, others emanate from external monitors. We therefore proposed specific hypotheses relating assessments of reputation to various informational signals emanating from firms and their audiences: market and accounting signals representing corporate performance, institutional signals depicting firms as more or less visible, attractive, and socially responsive, and strategy signals defining firms' corporate postures. We tested this model of reputation building with data from a set of *Fortune* 500 firms.

REPUTATION BUILDING: INTERPRETING AMBIGUOUS SIGNALS

Just as firms compete for customers, so also do they vie for reputational status. Publics construct reputations from available information about firms' activities originating from the firms themselves, from the media, or from other monitors. Publics use and propagate information they deem important for assessing firms' successes and failures at acquiring resource inputs, improving throughputs, and sustaining outputs. As signals about firms' activities, achievements, and prospects diffuse, individual interpretations aggregate into collective judgments that crystallize into reputational orderings of firms in organizational fields (DiMaggio & Powell, 1983). Established reputations themselves are signals that also influence the actions of firms' stakeholders.

Reputational rankings constitute a potentially significant and understudied form of normative control that channels firms' actions by conferring relative competitive advantage and disadvantage upon conforming organizations within an organizational field (Shapiro, 1987; Shrum & Wuthnow,

1988). If firms value their reputations, the desire to protect them can inhibit them and their managers from engaging in activities constituents deem unacceptable. Established reputations may, therefore, impede managers' strategic responses to environmental events and are thus a distinct source of intraindustry structure (Caves & Porter, 1977).

Fombrun and Zajac (1987), for instance, demonstrated how top managers' perceptions of environments induced different patterns of intraindustry stratification—and hence of rivalry—than predictions based on purely structural variables suggested. If reputational rankings are widely publicized (as, say, *Fortune*'s have become), they may alter managers' perceptions of environmental threats and opportunities and of their firms' strengths and weaknesses (Dutton & Jackson, 1987) and so influence the mobility barriers that managers enact: Well-reputed firms have a competitive advantage within their industries, but poorly reputed firms are disadvantaged. As Wilson pointed out, "the essential requirement for a player's reputation to matter for his current choice of action is his anticipation that his later decisions will be conditioned by his later reputation" (1985: 27).

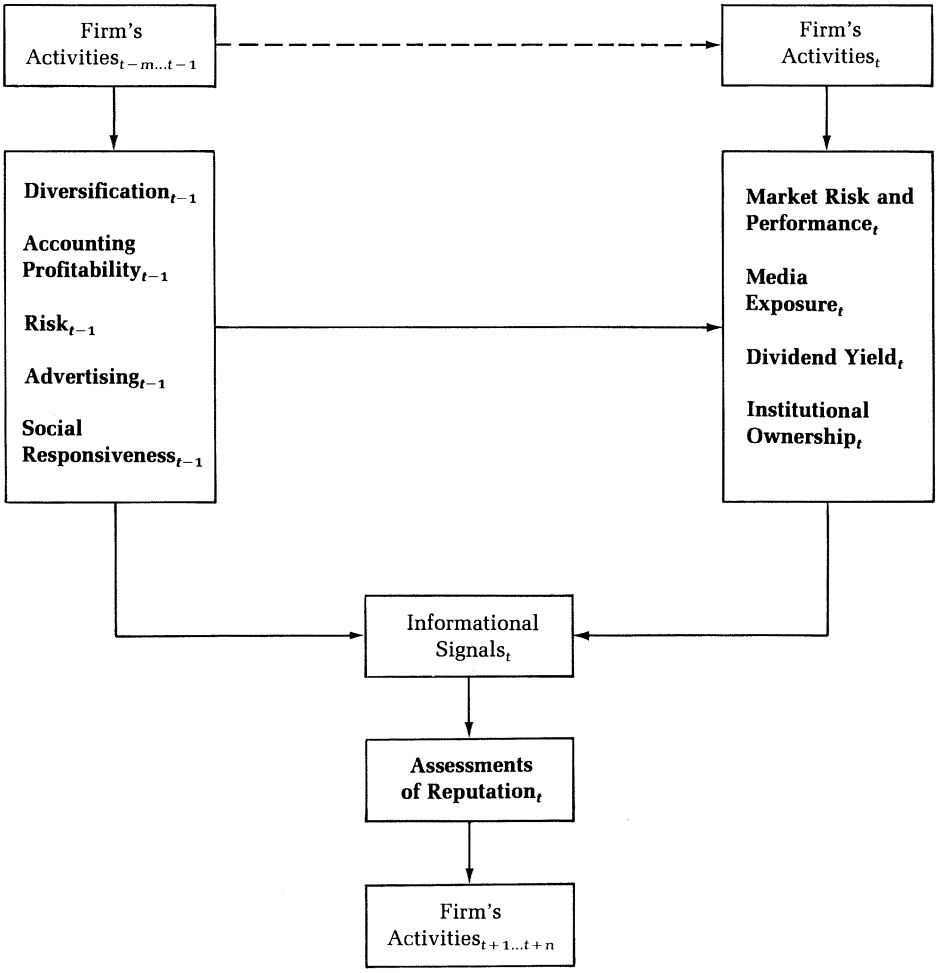
Since different publics attend to different features of firms' performance, reputations reflect firms' relative success in fulfilling the expectations of multiple stakeholders (Freeman, 1984). The more informational asymmetry and ambiguity characterize the interactions between managers and stakeholders, the more likely the latter are to search for information (Shrum & Wuthnow, 1988).

With homogeneous evaluators and informational symmetry between managers and constituents, reputations would be irrelevant and epiphenomenal. Figure 1 presents a model of reputation building under the more realistic conditions of incomplete and ambiguous information and heterogeneous publics. The figure suggests that reputations represent publics' cumulative judgments of firms over time. By showing how previous evaluators have resolved ambivalence in firms' performance, reputations inform publics about current ambivalence and influence firms' actions. As Wilson wrote about reputation building among individuals,

> Differences in the information available to participants make their strategies acutely sensitive to their beliefs and expectations. This in turn affects the behavior not only of the uninformed person, but also of the informed one, who realizes that his current actions affect others' later beliefs, their expectations about his subsequent behavior, and ultimately their choice of actions. Knowing that this chain of events will occur, the informed person has an incentive to trade off the immediate consequences of his current decision against the long-term effects of his reputation (1985: 59).

Although in this study we only addressed the determinants of reputation, reputational consequences are also worthy of considerable attention in future research. Economists model many apparently inconsistent behaviors

FIGURE 1
Model of Reputation Building Under Conditions of Incomplete Information[a]



[a] All constructs estimated in the analyses are in bold typeface.

by assuming that reputations are assets in which individuals and firms invest, requiring them to trade short-term pay-offs for long-term benefits (Wilson, 1985). Such an investigation would require a strong theoretical model capable of recognizing the simultaneous contributions to subsequent profitability of both a firm's prior reputation and its entire performance history and including other industry- and firm-level variables and evaluative criteria with varying time lags. Lacking such a model, McGuire, Sundgren, and Schneeweis (1988) may have concluded prematurely that a reputation for

social responsibility had little effect on various measures of performance.[1] Nonetheless, we agree with those researchers that in the short run, "it may be more fruitful to consider financial performance as a variable influencing . . . [reputation] than the reverse" (1988: 869).

This study investigated hypotheses derived from the notion that firms compete for reputation in a market characterized by incomplete information. In framing hypotheses, we followed the outline of Figure 1 and assumed that corporate audiences attend to market, accounting, institutional, and strategy signals about firms.

Market Signals

Market signals present information to constituents about firms' current activities, results, and prospects. External analysts, creditors, and investors are particularly attuned to the market performance of firms and routinely incorporate such data in their trading decisions (Fama, 1970). Through informal networks and formal reports, their assessments of firms' prospects diffuse through capital markets and contribute information to other publics' judgments (Shrum & Wuthnow, 1988).

Market performance and market risk. High performance and low risk predispose constituents to assess firms and their managers favorably. Klein and Leffler (1981) proposed a model explaining the price premiums firms obtain for high-quality products in terms of requiring investments in nonsalvageable assets like advertising and charitable contributions to maintain consumer purchases, particularly in the case of products whose merits are not verifiable prior to purchase. Just as prices signal product quality to consumers, high economic performance signals a firm's inherent quality to investors and creditors.[2] Firms that report high performance and low risk

[1] The high correlation (.41) McGuire and colleagues (1988) reported between 1982 reputation for social responsibility and average ROA for 1982–84 is deceiving. Not only does such a bivariate analysis fail to control for multiple firm- and industry-level influences on ROA, it also glosses over the joint influence of a firm's performance history on both reputation and values of ROA. A better estimate is obtained by correlating the residuals obtained from two regressions of (1) ROA_{t-2} and ROA_{t-1} on ROA_t and (2) ROA_{t-2} and ROA_{t-1} on $reputation_{t-1}$. We ran these analyses for three years of data and obtained the following.

Variables	Simple Correlations	Correlations of Residuals
1982 reputation × ROA, 1983	.45***	.09
1982 reputation × ROA, 1984	.41***	.07
1982 reputation × ROA, 1985	.26***	−.03

*** $p < .001$

The nonsignificant correlations between the residual scores indicate that a stronger model is required to investigate the implications of reputation for subsequent performance.

[2] The analogy may appear somewhat stretched since firms do not as a rule select performance levels. However, managers are known to manipulate accounting data to present a clean balance sheet or to reduce their tax liability. Often, they also take aggressive action to boost their stock price or otherwise influence market value.

convey information to the capital markets and other constituencies about the proven merits of their strategic trajectories and future prospects. Optimistic projections in turn incline some publics to purchase those firms' equity offerings, thereby increasing their market value and also signaling other publics that the firms have the inherent potential to meet some of their objectives, be they economic or social. The market value and market risk of firms provides investors and their advisors, as well as firms' competitors and other auditors, with both firm-specific and comparative information. Ceteris paribus, investors prefer high market returns and low market risk, suggesting:

Hypothesis 1: The greater a firm's current market performance, the better its reputation.

Hypothesis 2: The greater a firm's current performance-adjusted market risk, the worse its reputation.

Dividend policy. Another aspect of market performance that investors attend to is a firm's dividend policy (Walter, 1971). Dividend payouts, however, can signal rival messages. Some publics may interpret high distributions as indicating that a firm has tapped a more profitable and protected niche than competitors, but others may regard high distributions as a signal that the firm's managers lack attractive investment opportunities capable of ensuring future cash flows (Ross, 1977). These expectations, however, should also influence the stock price of the firm, increasing it in the first case and decreasing it in the second. The dividend yield—a ratio of dividend payout to stock price—is therefore a useful indicator of whether publics take a short- or long-run view of firms. Ross and Westerfield suggested that "firms with high growth prospects will generally have lower dividend yields" (1988: 41). If publics take a long-term view when they assess the reputational status of a firm, then

Hypothesis 3: The greater a firm's current dividend yield, the worse its reputation.

Accounting Signals

Accounting data provide an obvious source of information to constituencies interested in firms' economic performance. Financial statements indicate both the current results of prior activities and the current resource allocations the firms' managers have made. They therefore signal the merits of firms.

Accounting profitability and risk. Since long-run effectiveness requires firms to be profitable,

Hypothesis 4: The greater a firm's prior accounting profitability, the better its reputation.

Ceteris paribus, however, publics are risk-averse: Constituents expect a high level of return from firms whose strategies demonstrate high levels of risk (Bettis & Mahajan, 1985). For two firms with similar levels of profitability, therefore, greater risk should negatively influence publics' assessments. Hence,

Hypothesis 5: The greater a firm's prior performance-adjusted accounting risk, the worse its reputation.

Institutional Signals

Economic outcomes are not the only source of information important to all firms' constituencies. Firms belong to institutional environments that influence constituents' assessments: institutions often hold their stock; some firms expend heavily on social welfare, frequently through their own foundations; and the news media propagate information about their activities.

Institutional ownership. Patterns of institutional ownership are known to affect the behavior of firms' managers. For instance, when institutions hold more of a firm's stock than individuals, managers invest less in R&D (Graves, 1988). The composition of investors in firms' shares arguably sends a strong signal to their other constituents. The more institutional investors there are, the more likely some publics are to view firms favorably, taking it for granted that careful screening by well-informed portfolio analysts led to the institutional purchase decision.

Hypothesis 6: The greater the concentration of a firm's equity among institutions, the better its reputation.

Social responsibility. Publics also judge how well firms respond to their noneconomic agendas. Perceptions of firms' concern for the wider society may influence judgments, with social responsiveness signaling that firms have achieved a mutualistic relationship with potentially powerful groups in their environments. Social and political involvement, of course, may tie in directly to a firm's continued ability to operate, or they may represent a means of thwarting environmental challenges from powerful stakeholders (Pfeffer & Salancik, 1978).

Managers can signal their firms' social concern by contributing to charitable causes, developing nonpolluting products, achieving equal opportunity employment, creating foundations, placing women and minority members on boards, or adhering to the Sullivan principles[3] (Lydenberg, Marlin, & Strub, 1986; Ryan, Swanson, & Buchholz, 1987). Managers presume that social responsiveness generates goodwill from employees, consumers, and other publics that enhances the long-run profitability and viability of firms and protects their own employment.

Hypothesis 7: The greater a firm's contributions to social welfare, the better its reputation.

Media visibility. Managers' strategic attempts to influence constituents contribute to propagating information that in turn gets disseminated through networks of interpersonal relations or interlocking corporate ties (Mizruchi & Schwartz, 1987) and through press articles and mass media presentations

[3] The Sullivan principles are voluntary guidelines proposed in the mid-1970s by the Rev. Leon Sullivan to encourage U.S. firms to implement nondiscriminatory labor practices in South Africa and to support progressive projects for blacks in the communities in which the companies operate (Lydenberg, Marlin, & Strub, 1986: 30–33).

(McQuail, 1985). The media themselves act not only as vehicles for advertising and mirrors of reality reflecting firms' actions, but also as active agents shaping information through editorials and feature articles (Fombrun & Abrahamson, 1988).

Publics also differ in how much importance they attach to the domains in which firms operate. Involvement in a turbulent domain, for instance, enhances a firm's media visibility. Just as information availability biases individual judgments (Tversky & Kahneman, 1974), the availability of information in an arena may shape a particular audience's assessment of firms' activities: Publics are more likely to perceive as important the domains that receive the greatest media attention (McQuail, 1985). Greater visibility can be expected of firms operating in controversial product-market domains (tobacco and biotechnology), in national and regional public policy debates (aerospace and defense), and in risky technologies (nuclear power and chemicals).

Both the mass media and specialized publications also propagate evaluations of firms. Again, much as the availability of information biases individuals' judgments (Tversky & Kahneman, 1974), so may the amount of information channeled through informal networks, the business press, and the mass media bias publics' constructions of firms' reputations. Firms frequently and nonnegatively touted by the media might therefore develop better reputations than other firms because they occupy more central positions in a social network (Burt, 1983). This suggests two principal hypotheses and an interaction:

> *Hypothesis 8: The greater a firm's current media visibility, the better its reputation.*
>
> *Hypothesis 9: The more nonnegative a firm's current media coverage, the better its reputation.*
>
> *Hypothesis 10: Nonnegative coverage and visibility have a positive, interactive effect on reputation.*

Firm size. As institutions in their own right, large firms tend to receive much public scrutiny. The availability of information may benefit large firms disproportionally by inflating audiences' familiarity with their activities (Tversky & Kahneman, 1974). Assuming that corporate audiences asked to rate firms' reputations less readily remember small firms,

> *Hypothesis 11: The larger the firm, the better its reputation.*

Strategy Signals

Publics also assess firms on the basis of the payoffs likely from their managers' choice of business and corporate strategies. At the business-unit level, firms develop differentiated strategic postures by allocating resources in different ways across functional areas (Fombrun & Ginsberg, 1989). At the corporate level, firms differ in their diversification postures or the degree to which their activities span multiple related and unrelated businesses

(Rumelt, 1974). The extent of a firm's diversification informs constituents about corporate managers' preoccupations and therefore signals the firm's future prospects.

Differentiation. Over time, advertising helps firms develop strategic positions that are differentiated from their competitors' and that provide them with a measure of goodwill from consumers and other stakeholders (Rumelt, 1987; Weiss, 1969). Advertising not only signals product and firm characteristics in ways that can reduce constituents' searches for information but also presents firms in a favorable light.

Common to economic models of reputation building is a view of advertising as a source of product and imaging cues designed to influence the perceptions of external publics. Strategic decisions represent choices for a sequence of games[4] in which firms advertise to reduce consumer search (Stigler, 1961), stabilize output disposal (Milgrom & Roberts, 1986a), and increase barriers to entry (Comanor & Wilson, 1974). Similar models can be formulated for firms' investments in ensuring inputs and improving throughputs. Just as advertising helps induce a protected strategic position that stabilizes sales, so can investments in improved supplier, customer, and employee relationships enhance the quality of firms' input supplies, improve their pool of new recruits, lower their labor costs, raise their productivity, and thereby build unique and protected strategic niches (Schuler & MacMillan, 1984).

If firms develop strategic postures from cumulative resource allocations across functional domains (Fombrun & Ginsberg, 1989), by deploying resources to research and advertising and by maintaining tightly knit cultures, stable supplier relations, and high-productivity technologies, managers signal constituents about firms' strategic postures and transform their own histories into reputations (Kreps & Spence, 1985). In particular, differentiation may result from advertising allocations.

Hypothesis 12: The greater a firm's advertising intensity, the better its reputation.

Diversification posture. Some constituents may interpret diversification as increasing efficiency because administrative costs are likely to fall if a firm adopts a conglomerate structure. Other constituents, however, may expect lowered efficiency from diversification because of functional duplication. The two interpretations may coexist among different publics, and which one is most influential may depend on the information available about managers' actions.

Diversification also spreads risk and provides firms with a hedge against downturns in single products or markets that some investors might welcome (Bettis & Hall, 1982). Some previous research has cautioned against broad diversification, however, and noted that the capital markets favor firms that only diversify into related product-market domains to capitalize on synergy

[4] For a current review of game-theoretic approaches to strategy, see Shapiro (1989).

(Bettis, 1981; Rumelt, 1974). Such interpretations, if believed by firms' constituents, suggest that relatedness enhances firms' reputations.

If reputations partly reflect publics' interpretations of the merits of firms' strategic postures, the reputations of unrelated diversifiers might decline, not only because constituents expect them not to capitalize on production synergies between domains, but also because inclusion under a broad corporate umbrella hampers actual capital allocations within divisions. Unrelated firms, for instance, may spirit cash away from profitable divisions instead of reinvesting it in needed R&D (Hoskisson & Hitt, 1988), spend less on advertising (Bettis, 1981), and carry a high percentage of debt (Barton & Gordon, 1988)—actions that may worsen a firm's external image and increase its perceived riskiness to investors.

Finally, corporate managers of unrelated diversifiers control the release of division-level data and may be less encumbered by the reporting requirements of public auditors than their counterparts in focused firms (Ronen, 1982). Unrelated diversification may make a firm more opaque to constituents because of corporate managers' greater ability to control the presentation of divisional results and activities in consolidated public statements. External audiences might therefore discount unrelated portfolios because informational signals about individual divisions may be ambiguous and distorted, may serve the purposes of incumbent managers, and hence may be more difficult to interpret than signals from focused firms. Jointly, these arguments suggest that

Hypothesis 13: The greater a firm's unrelated diversification, the worse its reputation.

Unrelated diversification may also make evaluation difficult and ambiguous by reducing the credibility and effectiveness of corporate information and advertising. Unrelated diversification obscures divisional contributions to corporate profitability, making external assessments of activities tentative. Moreover, the trend toward takeovers and "deconglomeration" in the mid-1980s may have made unrelated diversifiers even more suspect to constituents (Galambos & Pratt, 1988). Since achieving synergistic relationships across unrelated businesses is a daunting task requiring the constant transfer of capital and know-how, we suggest that, lacking detailed and credible information about divisions, publics may be driven to rely on a broader set of signals in assessing firms with high levels of unrelated diversification.

Hypothesis 14: The determinants of reputation are more varied for unrelated diversifiers than for focused firms.

DATA AND METHODS

The 292 firms included in *Fortune*'s 1985 study of corporate reputation constituted the set of firms for this analysis. The *Fortune* survey, which solicited ratings of corporate excellence from 8,000 executives, outside directors, and securities analysts, had a 50 percent response rate (Hutton,

1986: 16–18). Respondents did not rate all the firms; they rated only those in their own industry or economic sector. Firms were rated relative to their principal competitors on eight attributes of reputation. We obtained summary data for the 1985 *Fortune* study from Erdos and Morgan, New York, the firm that conducted the study.

Accounting data for these firms were obtained from Standard and Poor's COMPUSTAT industrial and business segment tapes, which include accounting information regularly reported by public firms to the Securities and Exchange Commission (SEC). Data were selected for the end of fiscal 1984 and represent the most highly publicized accounting information available to respondents at the time they were surveyed.

Market performance and institutional ownership data came from the *O'Neill Datagraphs* (William O'Neill and Company, Inc., 1985). Data on media citations throughout 1985 came from the *Business Periodical Index* (H. W. Wilson Company, 1986). We obtained data on 1984 charitable contributions from the *Taft Corporate Giving Directory* (Taft Group, Inc., 1986), the *Corporate Foundation Profiles* (Foundation Center, 1986), and *Corporate 500: The Directory of Corporate Philanthropy* (Public Management Institute, 1986). Data on foundations were coded from *The Foundation Directory* (Foundation Research Center, 1985).

COMPUSTAT data for regularly reported variables were not available for all 292 firms *Fortune* reported on, resulting in the loss of 23 firms because of missing data or post-1984 mergers, acquisitions, and divestitures. We referred to the 269 remaining firms as group 1. The inclusion of advertising expenditures—data not regularly reported to the SEC—and charitable contributions further reduced the study set to 157 firms (group 2). Use of models including diversification data further reduced the set under investigation to 119 firms (group 3).[5]

Representativeness

Since both the survey design and missing values made the final set of firms nonrandom, we investigated the extent to which the two subsets, groups 2 and 3, were representative of the *Fortune* sample (group 1). Firms included in group 2 differed significantly from excluded firms on sales, income, and number of employees. When these variables were standardized to sector means and standard deviations, the only significant difference was in 1984 sales ($p < .01$). The results of *t*-tests on group 3 firms showed that they had no significant differences from group 2 firms but had significant differences in size (measured as sales and income) from firms excluded from group 3. These differences remained after we had controlled for sector ef-

[5] The number of firms in groups 2 and 3 actually used in the analyses reported in Table 3 were further reduced to 154 and 115, respectively, because of missing values on firms' risk for which complete data were required for 1975–83.

fects. Excluded firms did not, however, differ significantly from included firms in either group 2 or group 3 on the key independent variables used in the analyses.[6]

To check that included firms were representative of the original set, we derived three regression models of reputation using three predictor variables for which we had complete data: profitability, size, and visibility. The first model was based on group 2 firms, the second on firms excluded by missing values from group 2, and the third on pooling the two sets of firms to reconstitute group 1.

All three models were nearly identical in the size and direction of their beta coefficients and explained 27–35 percent of the variation in reputation. A Chow test showed no significant difference between included and excluded firms ($F_{3,272} = 2.08$, $p > .10$). We calculated differences between predicted values for each pair of models and found them to be normally distributed around a mean of zero. There was therefore no reason to suspect that the form of the relationship between variables would be different for excluded firms than for included firms because of missing data on predictor variables.

Measures

Corporate reputation. The dependent variable was reputation, an index formed from ratings respondents provided on eight 11-point scales (0 = poor, 10 = excellent) to the *Fortune* survey, which was conducted between September and December of 1985.[7] The survey began by asking respondents to name the leading firms in an economic sector and continued: "How would you rate these companies on each of the following attributes: quality of management; quality of products or services; long-term investment value; innovativeness; financial soundness; ability to attract, develop, and keep talented people; community and environmental responsibility; and use of corporate assets?"

Previous studies using *Fortune*'s ratings have relied on single dimensions and typically investigated either the correlates of one dimension of reputation or its consequences. For example, McGuire, Sundgren, and Schneeweis (1988), Conine and Madden (1986), and Chakravarthy (1986) all investigated social responsibility. The pattern of correlations among these

[6] Differences between included and excluded firms reflect the fact that smaller and less profitable firms do not advertise as much or give as much to charity as larger, more profitable firms do. However, this fact did not prevent our generalizing from the results of analyses of included firms to excluded firms.

[7] *Fortune* declines to specify the exact time during which the survey was conducted. Since they announced the study in August 1985 and provided summary results in January 1986, we concluded that all questionnaires were filled out during the last quarter (September–December) of 1985. All market measures used in this study were therefore estimated for September 27, 1985.

dimensions suggests that this is not a valid approach since they are not conceptually distinct and demonstrate considerable empirical relatedness.

To overcome the limitations of analyzing separate dimensions of reputation, we created an index of overall reputation from the eight single dimensions ($\alpha = .97$). A varimax factor analysis of the eight attributes extracted a single factor with an eigenvalue of 6.68 that accounted for 84 percent of the variance. Factor analyses of other surveys conducted by *Fortune* in the last quarters of 1982, 1983, 1984, and 1986 supported the stability of this factor solution and justified our conclusion that the eight attributes elicited from respondents were components of an underlying and stable construct of reputation. We adjusted overall reputation for sector differences since the *Fortune* survey asked people to assess firms' reputations in comparison to those of other firms competing in the same primary sector. We also used the three additional scores for reputations at the end of calendar years 1982, 1983, and 1984 in a cross-sectional time series model.

Sector. All variables in the analyses reported below were normalized with respect to the means and standard deviations of the economic sectors defined in *Fortune*. These sectors are similar, though not identical, to two-digit Standard Industrial Classification codes and represent the primary economic involvements of firms in the study.[8] Normalization by these sectors, though imperfect, makes firms roughly equivalent in terms of primary economic or historical commitments and is especially justified because the *Fortune* survey asked respondents to rate firms relative to other firms in the same primary sector (Hutton, 1986: 16–18).

Size. Size was computed as a logarithmic transformation of total sales in 1984.

Economic performance. Economic performance was gauged in three ways: (1) by prior-year accounting profitability, measured as return on invested capital (ROIC) at the end of fiscal year 1984, a measure that is independent of capital structure (Nathanson, 1980); (2) by the ratio of market to book value (for September 27, 1985), a measure that captured market value just prior to the assessments of firms' reputations in fall 1985; and (3) by the yield, for September 27, 1985, a ratio of the prior four quarters' dividends divided by share price on that date.

Riskiness. The level of accounting risk in 1984 was estimated by the coefficient of variation (the ratio of the standard deviation to the mean) of ROIC in the previous nine years, 1975–83 (Martin & Gray, 1971). A market measure of risk was gauged by firms' beta coefficients on September 27, 1985. Beta coefficients are commonly used measures of the systematic risk of a firm—the degree to which movement in a firm's stock is associated with general stock market movements.

[8] We use the term "sector" to distinguish these domains of economic activity from "industry," a term increasingly applied to business-level activity at the four-digit SIC code level.

Institutional ownership. The concentration of a firm's stock in institutional hands was estimated as a variable called institutional ownership, representing the percentage of all outstanding shares held on September 27, 1985, by banks, insurance companies, and mutual funds.

Media exposure. Media visibility was estimated as the total number of articles written about a firm in 1985, the calendar period most closely matching the period during which this survey's respondents would have formed their individual judgments of firms. We included the full year because of uncertainty about the actual timing of survey responses. We also tabulated the month-to-month distribution of articles for a 10 percent random sample of firms to check for bias in the timing of articles during the year. Although there was variation for individual firms, the aggregate distribution of articles throughout the year was not significantly different from the distribution of a random sample drawn from a uniform distribution ($t = 1.4$, $p > .20$), suggesting that there would be no systematic bias from using the full year of news reports. The resulting indicator was adjusted for both sector and size effects because we expected variations in the firms' sizes to skew the distribution of media citations and expected differences in coverage between sectors. A rater then content-analyzed the titles of the 15,400 articles found and classified each as indicating either positive or negative news about a firm.[9] Announcements concerning performance, new products, or a new CEO were "good" news, and news about crises, regulation, or federal investigation was "bad." To check the reliability of the index, three raters independently rated a 10 percent subset of the articles (2,132 titles); agreement with the principal rater was high, with a .88 coefficient of reliability. We therefore created a favorability index, calculating the degree to which media reports were not negative as the proportion of positive and neutral ratings received.

Differentiation. A firm's total advertising expenditures in 1984, adjusted for firm size, was the measure of advertising intensity. We estimated a firm's charitable contributions during 1984, adjusted for firm size,[10] for the measure "charity." A dummy variable called foundation was used to distinguish between firms that had a separately endowed foundation in 1984 through which they funneled charitable contributions and those with no such foundation.

Diversification. COMPUSTAT's business segment tape provides data on firms' annual sales by segment, a business domain that can encompass both

[9] We considered coding a "neutral" category but found it less reliable than "positive" and "negative." Raters tended to either over- or underuse the neutral category. Very few items proved difficult to code into the more restrictive categorization, and those were eliminated.

[10] We also tried adjusting charitable donations for net income rather than total sales to account for the possibility that firms might use different rules of thumb in budgeting resources to advertising (total sales) and to charitable causes (prior net income) (Burt, 1983). The results were similar to those with the reported variable.

four- and two-digit SIC code levels. Up to 2 four-digit codes are reported for each segment. From these data, we created a continuous Herfindahl-type[11] measure of diversification across segments at the end of fiscal year 1985, calculated as $1 - (\sum_j \text{Sales}_j^2)/(\sum_j \text{Sales}_j)^2$, where j = the number of segments.

As Montgomery (1982) showed, this measure is highly correlated with Rumelt's (1974) categorical measure of relatedness, so firms with high scores on the index are more likely to encompass less related businesses under their corporate umbrellas than firms with low scores on the index. However, the COMPUSTAT data base does not report the exact percentage of segment sales in each four-digit business. To better account for relatedness, we therefore assigned segment-level sales equally to distinct four-digit industries only when they did not fall under the umbrella of the same two-digit sector (Amit & Livnat, 1988; Wally, 1989).

Analyses

Table 1 presents the basic descriptive statistics for all the independent variables incorporated in the analyses and the intercorrelations among these variables after adjustment for economic sector. The low intercorrelations among adjusted predictor variables used in the models gave us no reason to suspect multicollinearity, and various diagnostic tests run on derived regression models confirmed that it was not a problem.

The analyses were carried out in three steps, the first of which was calculation of a cross-sectional time series model that explains reputation in terms of four signals derived from prior-year accounting data.

Second, we modeled market measures as a function of prior-year accounting information. Since market measures already embody publicly available information about firms, we created standardized residual scores for the market-book ratio, beta, yield, and visibility, the only variables for which prior-year accounting data had strong effects. The residual scores ensured the independence of those variables from profitability, risk, advertising, and size and represented the information remaining in the variables after the influence of previously distributed, readily available accounting information had been removed. We then incorporated these residuals into models of corporate reputation designed to test the hypothesized relationships presented in Figure 1.

Third, to investigate the effects of informational signals on the reputations of firms with differing levels of diversity, we split the subset of firms for which diversification level could be calculated at the median value of their ratings on that variable. We created the two groups to see if publics rely on different informational signals in constructing the reputations of diversified firms of greater or lesser relatedness.

[11] For a detailed discussion of Herfindahl-type and related entropy measures, see Amit and Livnat (1988).

TABLE 1
Descriptive Statistics[a]

Variables	Means	s.d.	Correlations[b]												
			1	2	3	4	5	6	7	8	9	10	11	12	13
1. Reputation	6.33	0.90													
2. Profitability	0.10	0.08	.44												
3. Risk	0.09	0.65	−.39	−.12											
4. Advertising	0.03	0.03	.27	.20	−.10										
5. Size	8.31	0.90	.22	.05	−.06	.28									
6. Institutional ownership	0.28	0.08	.24	.12	−.10	−.07	−.05								
7. Market-book ratio	1.76	0.95	.49	.48	−.26	.16	−.05	.05							
8. Beta	1.07	0.39	−.28	−.23	.17	−.31	−.30	.06	−.29						
9. Yield	0.35	0.16	.00	.01	−.20	.12	.28	−.07	−.15	−.17					
10. Visibility	0.02	0.01	−.26	−.18	.07	−.03	−.18	.02	.03	.07	−.04				
11. Favorability	0.87	0.18	.31	.15	−.05	.03	.11	.16	.26	−.04	.08	−.34			
12. Charity	0.01	0.01	.18	.05	−.01	.15	.03	.09	.02	−.17	.03	.01	.23		
13. Foundation	0.74	0.47	.17	.12	.01	.09	.00	−.03	.00	.01	.11	−.15	.04	.03	
14. Diversification	0.47	0.25	−.24	−.15	−.03	−.01	.09	−.04	.02	−.07	.29	−.06	.04	.04	−.04

[a] All means and standard deviations shown are prior to standardization by sector. $N = 154$, except for correlations with diversification, for which $N = 115$.

[b] All correlation coefficients greater than .1 are significant at $p < .05$.

RESULTS

Through a two-way cross-tabulation of firms by their median scores on reputation and accounting profitability after adjustment for sector, we classified 51 firms as either low reputation–high profitability or high reputation–low profitability. Together, these categories represented 30 percent of the firms under study, and noneconomic informational cues appeared particularly relevant to explaining their reputations. Despite the firms' relatively high profitability, for instance, publics assigned worse reputations to such diverse firms as Pepsico, Polaroid, and RCA, suggesting that constituents are judging the prospects of these firms on other than accounting profitability. Similarly, firms like Eastman Kodak, Merrill Lynch, General Electric, Texas Instruments, and Gencorp enjoyed better reputations than their profitability levels would warrant. On what basis did constituents form judgments of these firms' prospects? To address this question requires multivariate models that incorporate more than accounting profitability as a predictor of reputation.

Cross-sectional Time Series

The influence of four variables for which we had complete data on the three-year time series of corporate reputations for the ends of fiscal years 1982, 1983, and 1984 were first investigated. Those data provide a first-order test of the influence that accounting signals have on constituents' assessments of reputation. Table 2 presents the standardized model.

The cross-sectional time series analysis on 557 firm-years indicates basic support for Hypotheses 4, 5, 11, and 12. As expected, assessments of reputation appear to be positively related to prior accounting profitability, advertising intensity, and size and negatively related to prior performance-adjusted risk. Although the pooling of firm-years violates the least-squares

TABLE 2
Cross-sectional Time Series Analysis of Corporate Reputation, 1982–84[a]

Independent Variables	Adjusted Reputation
Profitability	.42***
Risk	−.21***
Advertising	.10**
Size	.17***
Adjusted R^2	.30***
df	4,552
F	21.45

[a] The independent variables were calculated for the year before the year of data collection; reputation is for the year of data collection.

** $p < .01$

*** $p < .001$

assumption of independence, a Durbin-Watson statistic of 1.94 suggests that autocorrelation did not seriously affect the stability of the model ($p < .01$).

Regression Models

To investigate the joint influence of both prior accounting information and current market and institutional signals on publics' assessments, we calculated various models that assess the influence of residual scores for the market-book ratio, beta, yield, and visibility against other informational signals. Table 3 presents results for these models.

Model 1 confirms the results of the cross-sectional time series analysis and provides significant support for Hypotheses 4, 5, 11, and 12, relating accounting signals to publics' assessments of firms. Profitability, advertising intensity, and size positively influence assessments of reputation, and accounting risk has a strong negative effect.

Hypotheses 1 and 3 were also supported. After residuals had been cal-

TABLE 3
Explaining Corporate Reputation in 1985[a]

	Models[b]			
Independent Variables	**1: All Firms**	**2: All Firms**	**3: Low Diversity**	**4: High Diversity**
Profitability	.33***	.21***	.27**	.21**
Risk	−.30***	−.40***	−.31**	−.41***
Advertising	.11†	.17**	.33**	.10
Size	.15**	.12**	.07	.25**
Institutional ownership	.18**	.11†	.20*	.07
Market-book ratio[c]	.23***	.29***	.31**	.19*
Yield[c]	−.17**	−.13†	−.07	−.27**
Visibility[c]	−.20***	−.15*	−.03	−.26**
Beta[c]	−.07	.10	−.17†	−.03
Favorability	.04	.03	.03	.20*
Favorability × visibility	.05	.07	.03	.25**
Charity	.10†	.07	.08	.03
Foundations	.15**	.13*	.10	.14†
Diversification		−.24***		
Adjusted R^2	.51	.53	.46	.63
df	12,134	14,100	13,44	13,43
F	13.46***	10.55***	4.83***	9.21***

[a] Beta coefficients are shown.

[b] For model 1, $N = 148$; for model 2, $N = 115$; for model 3, $N = 57$; and for model 4, $N = 58$.

[c] This is a residual variable calculated from regressions against profitability, risk, size, and advertising.

† $p < .10$
* $p < .05$
** $p < .01$
*** $p < .001$

culated, both the market-book ratio and dividend yield provide additional information and significantly influence constituents' evaluations: high market-book ratios and low dividend yields induce constituents to assign high reputations to firms over and beyond the effects of accounting profitability, advertising intensity, size, and risk. The data did not, however, support Hypothesis 2. Residual information embodied in firms' beta coefficients does not appear to influence reputations.

Hypothesis 6 predicts that institutional ownership will positively affect reputations. Model 1 corroborates the hypothesis that publics tend to assign higher reputations to firms with a high proportion of stock held by banks, insurance companies, and mutual funds.

Hypotheses 8–10 propose that firms' exposure through the media will significantly influence reputational judgments. The results indicate that residual visibility negatively influences reputations, refuting Hypothesis 8: With size controlled, model 1 suggests that the higher a firms' visibility per unit of sales and hence the greater the scrutiny of the firm by the press, the worse its reputation. Contrary to expectations, model 1 also fails to provide support for Hypothesis 9, stating that the greater the volume of nonnegative coverage, the better a firm's reputation. Nor does there appear to be any interaction between nonnegative coverage and the intensity of scrutiny of firms by the media, as Hypothesis 10 proposes.

Figure 1 suggested that firms' responsiveness to social concerns would positively influence publics' assessments. The significance of the beta coefficients for the charity and foundation variables support Hypothesis 7: Publics assign higher reputations to firms that have foundations and give proportionally more to charity than other firms.

Altogether, the results of model 1 provide significant support for the hypotheses shown in Figure 1. The strengths of the variables' contributions to explained variance can be examined by comparing the beta coefficients. In descending order of importance, they are: (1) accounting signals of profitability and risk, (2) market valuation, (3) media visibility, (4) dividend yield, (5) size of firm, and (6) boundary-spanning through foundations, charitable contributions, and advertising.

Diversification

In model 2, we added the Herfindahl measure of firm diversification to model 1. The results indicate that diversification tends to negatively influence publics' assessments of reputation, supporting Hypothesis 13. Since the beta coefficients of the other variables change, however, model 2 suggests that publics may draw on different informational inputs in constructing the reputations of firms of various levels of diversification. To examine the signals used in constructing these reputations, we calculated models 3 and 4, which present the results of model 2 broken out at the median value of diversification. Following Montgomery (1982), we assumed that firms with low diversification tended to be more focused and that firms with high diversification were involved in a broad range of businesses.

A Chow-test comparison of models 3 and 4 suggests that breaking out by degree of diversification improves upon model 1 ($F_{13,85} = 2.67$, $p < .01$). To further test for significant differences between firms of low and high diversity, we computed a set of moderator regression models by introducing interactions of each variable with diversification. Diversification only significantly moderated the effects on reputation of media visibility ($p = .09$), nonnegative media appraisals ($p = .03$), the interaction of visibility with those appraisals ($p = .002$), size ($p = .11$), and dividend yield ($p = .15$), with the last two effects relatively weak. Given this pattern and the results of models 3 and 4, the results appear consistent with Hypothesis 14: Publics appear to rely on different criteria and a broader range of informational inputs to assess the reputations of diversified firms than they use to interpret the activities of focused firms.

DISCUSSION

Economists have proposed dynamic models to explain why firms invest in reputation building (Weigelt & Camerer, 1988; Wilson, 1985). They have neglected to consider, however, the institutional context within which reputations develop. In this study, we emphasized the social community within which firms themselves are embedded and the central role played by firms, constituents, and the media in influencing the informational context within which reputational judgments are made. Economists may benefit from accommodating such an institutional understanding of corporate reputations in their game-theoretic models.

The results of this study support an understanding of firms as involved in a competitive market for reputational status in which, because of informational asymmetries, firms signal their key characteristics to constituents. Consistent with the logic of Figure 1, our findings show that publics appear to construct reputations from a mix of signals derived from accounting and market information, media reports, and other noneconomic cues. Firms' risk-return profiles, resource allocations, social responsiveness, institutional ownership, media exposure, and corporate diversification postures signal constituents about firms' prospects and generate reputations.

The analyses confirmed our suspicion that a limited bivariate analysis linking short-term profitability to reputation would be misleading: The multivariate models suggest that historical performance and other noneconomic cues also influence reputations, and that must be true particularly for the 51 firms for which reputations and short-term profitability were out of line.

A broad range of economic and noneconomic signals emanating from firms help predict publics' reputational orderings within sectors. Most significantly, and as expected, accounting measures of profitability and risk and market value most strongly affected judgments of firms. Also important, however, were firms' reflected visibility in the media, the extent to which institutions held their stock, their dividend yield to investors, and their demonstrations of social concern.

If managers can strongly influence reputational assessments by involving themselves in boundary-spanning activities with consumers, investors, and society at large, it is also true that the actions of institutional investors and media accounts heavily condition their firms' reputations. Banks, insurance companies, and, increasingly, investment funds occupy central positions in the economy (Mintz & Schwartz, 1985). Our results suggest that by purchasing a firm's equity in capital markets, institutional investors signal constituents about the merits of the firm's activities. Since these signals are incorporated into constituents' reputational assessments, they may constitute a path through which institutional investment patterns influence managers themselves and possibly alter competitive dynamics in industries.

The finding that intensive media scrutiny has a strong negative effect on firms' reputations was surprising, particularly since it did not matter whether those ratings were favorable or unfavorable, except for diversified firms, for which nonnegative press improved reputation. We suggest three explanations: (1) media reporters deem newsworthy only events that impugn corporate managements, (2) external publics react negatively to all forms of publicity, and (3) only negatively predisposed evaluators rely on media accounts of firms.

However, since this study's coder rated an average of 87 percent of the article titles analyzed as not negative, the business media do not appear to be predominantly negative in their reviews of firms. Moreover, a scan of selected news reports indicated that detailed accounts varied widely in tone, making them inherently ambiguous informational vehicles. Finally, it seems difficult to defend the view that evaluators who rely on media-generated signals are inherently negative.

The data in Table 3 demonstrate the interaction of diversification with media exposure. Since media visibility, the extent of nonnegative coverage, and the interaction of visibility and nonnegative coverage do not influence publics' assessments of focused firms but are all significant for diversified firms, we propose that constituents rely on media accounts in the absence of confidence in firm-generated data. Since benefits only accrue to diversified firms at the cost of increased complexity (Montgomery, 1985), it may be that publics turn to the media because information is either too difficult to obtain from these firms directly or is seen as unreliable when it is so obtained.

More broadly, the influence of diversification on the reputation-building models suggests that publics draw on different and fewer sources of information in making judgments about focused firms than they do when making judgments about diversified firms. Diversification itself appears to encourage publics to broaden their search for information when constructing their assessments. In contrast, the publics of focused firms construct their judgments principally from accounting and market measures of both performance and risk, institutional ownership patterns, and advertising (Milgrom & Roberts, 1986a). We therefore speculate that focused firms appear more easily interpretable to evaluators, making economic signals less ambiguous

and their reputations less susceptible to influence by the media and other external monitors.

CONCLUSIONS, LIMITATIONS, AND FUTURE RESEARCH

This study made a preliminary attempt to fuse economic and sociological approaches to the study of firms' interactions with their publics. Little previous empirical research has viewed firms as involved in a competitive market for reputational status. Yet, the judgments of publics collectively create reputations that stratify industries, with potentially significant competitive advantages accruing to firms with higher perceived reputational status (Caves & Porter, 1977; Weigelt & Camerer, 1988). This study demonstrated how students of strategy might benefit from investigating the informational bedrock upon which firms' reputations rest.

Future research should attempt to specify the particular interpretive process through which firms' investments become cognitions in the minds of individual constituents, whether based on product and image advertising or on firms' internal commitments of funds to R&D or their labor force. Firms actively intrude into their environments, not only through resource deployments (Pfeffer & Salancik, 1978), but also through social networks (Laumann & Knoke, 1987; Shrum & Wuthnow, 1988) and carefully disseminated self-presentations like annual reports (Ryan et al., 1987; Salancik & Meindl, 1984). Much as employees in organizations invest in activities to win promotions, so may organizations invest in activities that afford them good marks in interorganizational fields (DiMaggio & Powell, 1983). Students of strategy should appreciate how firms' actions intertwine with those of rivals through elaborate networks of constituents to create a distinct social collectivity with emergent properties (Fombrun, 1986).

Methodologically, researchers should attend to the longitudinal process through which reputations attain stability and structure. Yearly budget allocations do not in and of themselves generate stable reputations; rather, the cumulative investments that firms consistently make in different domains over long time spans are more likely to influence the cognitive interpretations of stakeholders. Although it may be reasonable to assume—as we did in this study—that the yearly budgets of large firms are highly correlated with their long-term total investments, future research could directly assess these cumulative investments. Like electromagnetic signals, reputations may have a long-term component that reflects cumulative investments. Short-term noise may, however, obstruct the transmission if cross-sectional analyses are relied upon. Even if reputations reflect long-term status orderings, they can change as a result of short-term actions, whether intentional or accidental. Separating the short- and long-term components of reputational signals should be the subject of much future debate in the analysis of corporate reputation building.

Another direction for future research lies in better specifying the dimensionality of the construct: Do firms have one reputation or many? Do repu-

tations significantly differ by either domain or audience? This study assumed a single underlying construct of reputation produced by aggregating findings across multiple domains. Factor analyses of the *Fortune* data we used here and the similarity of the respondents in the study to other audiences firms confront supported that assumption. A more extensive study of reputation might enrich our understanding of the construct by including other audiences with which firms interact, such as consumers and employees. Incorporating more domain-specific components might make it possible to distinguish central and peripheral influences on firms' reputations.

Although cash disbursements had considerable signaling value for the publics' studied, future research might also consider if short-term jolts such as CEO successions, mergers, acquisitions, joint ventures, and new product developments affect reputations in the way they affect stock market behavior. Corporate catastrophes like Union Carbide's 1985 Bhopal accident and the failure of Continental Illinois in 1984 undoubtedly damage reputations. How long-lived are these effects? Does competent handling of crises dampen their negative effects? Johnson and Johnson's successful turnaround of the Tylenol crisis in 1984 suggests that competent handling may well moderate the reputational effects of environmental jolts.

Finally, analyses of the consequences of established reputations—and major changes in reputations—for competitive dynamics in an industry are needed to complement this research. Positive reputations are often said to attract investors, lower the cost of capital, and enhance the competitive ability of firms. Managers may strive to enhance employee welfare, not only to increase the likelihood of compliance with directives, but also to signal potential workers about working conditions and internal norms (Kreps & Spence, 1985; Spence, 1974). In turn, firms that develop reputations for attending to employee welfare may find themselves in a good bargaining position in labor markets, attract better applicants, and achieve lower costs (Stigler, 1962). However, few empirical studies have actually demonstrated these effects, probably because, as we have argued, a firm's acquired reputation is only likely to affect performance marginally. Investigating reputation's influence requires a fully articulated model of organizational performance that also acknowledges the effects of market, product, and strategy variables. To tease out the marginal effect of reputation on performance would therefore require extending the present analyses over time and developing, in tandem with surveys like *Fortune*'s, a data base of strategic, market, and environmental variables that would allow the matching of changes in reputation with changes in underlying influents and thus enable the modeling of joint consequences.

If reputations confer competitive advantage, they constitute important barriers to firms' mobility within industries and into related or unrelated industries. How resilient are reputations, how sound an investment, how much of an asset? To identify the effects of reputation on mobility, competitiveness, and ultimately, on performance, is a formidable and potentially rewarding research challenge.

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