An Examination of Differences Between Organizational Legitimacy and Organizational Reputation*

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ABSTRACT Organizational legitimacy and organizational reputation have similar antecedents, social construction processes and consequences. Nonetheless, an improved understanding of relationships between legitimacy and reputation requires that differences between the two be specified and clarified. Our examination of past research indicates that legitimacy emphasizes the social acceptance resulting from adherence to social norms and expectations whereas reputation emphasizes comparisons among organizations. We empirically examine two antecedents of the financial, regulatory, and public dimensions of legitimacy and reputation in a population of US commercial banks. We find that isomorphism improves legitimacy, but its effects on reputation depend on the bank’s reputation. Moreover, higher financial performance increases reputation, but does not increase the legitimacy of high performing banks.

INTRODUCTION

Organizational legitimacy and organizational reputation are two concepts representing assessments of an organization by a social system. Legitimacy has had a major impact on many organization theories, including institutional theory (Meyer and Rowan, 1977), resource dependence theory (Pfeffer and Salancik, 1978), and organizational ecology (Carroll and Hannan, 1989). The concept’s frequent appearances prompted Suchman (1995, p. 571) to observe that legitimacy is ‘an anchor-point of a vastly expanded theoretical apparatus addressing the normative and cognitive forces that constrain, construct, and empower organizational actors.’

Interest in organizational reputation ignited in the last two decades. The business and popular press, such as Fortune, The Financial Times, and US News & World Report fuelled this fire by publishing reputational rankings of businesses and uni-
versities. Reputation has played a role in status theory in sociology (Shrum and Wuthnow, 1988), the resource-based view of the firm in strategy (Hall, 1992) and game theory in economics (Weigelt and Camerer, 1988).

As currently understood, there are many similarities between the two concepts. Firstly, they result from similar social construction processes as stakeholders evaluate an organization (Ashforth and Gibbs, 1990; Fombrun and Shanley, 1990). Secondly, the concepts have been linked to similar antecedents, such as organizational size, charitable giving, strategic alliances, and regulatory compliance (Fombrun and Shanley, 1990; Galaskiewicz, 1985; Oliver, 1990; Stuart, 2000). Thirdly, an important consequence of both is the improved ability to acquire resources (Hall, 1992; Suchman, 1995). Reviews for each concept can be found in Suchman (1995) and Ruef and Scott (1998) for legitimacy, and in Fombrun and van Riel (1997) and Fombrun (1996) for reputation.

These similarities indicate substantial conceptual overlap between legitimacy and reputation. Such overlap often occurs in theory building because concepts are in flux as the theories incorporating them develop (Kaplan, 1964; Stinchcombe, 1968, p. 40). As Wright (1985, p. 292) observed: ‘The process of concept formation is always simultaneously the process of concept transformation’.

Although efforts to develop and test theories of legitimacy and reputation are laudatory, there has been limited research distinguishing the two concepts. We help to fill this gap so that future research can develop a better understanding of the relationships between legitimacy and reputation (Kaplan, 1964). Thus, the main purpose of this paper is to examine the distinctive properties of legitimacy and reputation and the degree to which similar antecedents produce different outcomes in the same empirical context.

We proceed as follows. Firstly, we highlight key differences in the definitions of legitimacy and reputation. Secondly, we examine two antecedents, isomorphism and financial performance, that may affect the legitimacy and reputation differently. We focus primarily on legitimacy and reputation at the organizational level of analysis, but our analysis could be extended to other levels. Our empirical analysis in a sample of commercial banks supports our conjectures. A discussion of implications and limitations concludes the paper.

THEORY DEVELOPMENT

Comparing Definitions of Legitimacy and Reputation

Although legitimacy and reputation have many similarities and have been mentioned in the same papers (e.g. Brown, 1997, p. 668; Elsbach, 1994, pp. 66, 69; Fombrun and Shanley, 1990, p. 233; Stuart, 1998, p. 674), efforts to distinguish the two concepts have been rare and empirical assessments of any differences nonexistent. Of the rare theoretical exceptions, two useful papers that distinguished
legitimacy and reputation are Lawrence (1998), a theory-building case study that examined the emergence of the forensic accounting profession, and Ruef and Scott (1998), which outlined a general model of legitimacy and statistically tested part of it using professional evaluations of hospitals as measures of normative legitimacy. These papers suggest two important criteria for distinguishing legitimacy and reputation: the nature of the assessment stated in the definition and the dimensions on which legitimacy and reputation can be assessed.

Legitimacy has been assessed in past definitions in terms of acceptability or acceptance (Brown, 1997, p. 664; Knoke, 1985, p. 222; Meyer and Rowan, 1977, p. 351), taken-for-grantedness (Carroll and Hannan, 1989; Meyer and Rowan, 1977), reasonableness, appropriateness, and congruence (Brown, 1998; Dowling and Pfeffer, 1975; Meyer and Rowan, 1977). Suchman (1995, pp. 573–4) presented an encompassing definition of legitimacy as ‘the generalized perception or assumption that the actions of an entity are desirable, proper, or appropriate’ within a social system. Thus, it appears that a central element of legitimacy, as currently understood, is meeting and adhering to the expectations of a social system’s norms, values, rules, and meanings (Hirsch and Andrews, 1984; Parsons, 1960). For example, Lawrence (1998) suggested that legitimacy indicates that one is qualified for a particular profession. That is, the person has the knowledge, skills, or competence to be a member of that profession. Ruef and Scott (1998) followed Scott (1995) and wrote that organizations must conform to normative rules, regulatory processes, and cognitive meanings. Some expectations can be explicit and set by professional associations, governments, etc. (DiMaggio and Powell, 1983); others can be implicit and emerge over time from interactions among participants in a social system (Edelman, 1992). Regardless of the source of these expectations (Ruef and Scott, 1998), social actors generally accept and take for granted legitimate organizations (Suchman, 1995).

In contrast to legitimacy, reputation has been assessed in past definitions in terms of relative standing or desirability (Shrum and Wuthnow, 1988), quality (Podolny, 1993), esteem (Dollinger et al., 1997; Fombrun, 1996, p. 37; Hall, 1992, p. 138; Heugens, 2004), and favourableness (Deephouse, 2000). Shenkar and Yuchtman-Yaar (1997) equated reputation with image, esteem, prestige, and goodwill in developing the encompassing concept of organizational standing, because all terms indicate the relative position of an organization amongst its counterparts. Ruef and Scott (1998) similarly highlighted status comparisons as central in reputation. At the individual level, Lawrence (1998) proposed that the reputation of a forensic accountant indicates expertise vis-à-vis other accountants. Thus, central to a reputation is a comparison of organizations to determine their relative standing. For any two organizations, they will either have the same reputation or, more likely, one will have a better reputation than the other.

A second way to distinguish legitimacy and reputation is by comparing the dimensions on which they can be assessed. We follow Ruef and Scott’s (1998, p.
recommendation that legitimacy assessments be restricted to those involving regulative, normative or cognitive dimensions. In contrast, reputation may be assessed on these dimensions but can also be assessed on ‘virtually any attribute along which organizations may vary that can serve as a source of status comparisons’. Thus, in this framework there are some attributes for which reputation can be evaluated but for which legitimacy cannot. For instance, one attribute could be the architectural merit of corporate headquarters’ buildings. What is critical, then, is comparing the nature of legitimacy and reputation assessments when using the same dimension.

Thus, we view legitimacy as the social acceptance resulting from adherence to regulative, normative or cognitive norms and expectations. In contrast, we view reputation as a social comparison among organizations on a variety of attributes, which could include these same regulative, normative or cognitive dimensions. In Lawrence’s terms (1998, p. 1122), reputation ‘differentiate(s) between the qualified [i.e., legitimate] and the “outstanding” forensic accountants’. We next develop a set of propositions that further distinguish legitimacy and reputation based on their antecedents.

**Differences in Antecedents: Isomorphism**

Antecedents of both legitimacy and reputation identified in past research include diversification strategies (Fliqstein, 1991, for legitimacy; Fombrun and Shanley, 1990, for reputation), charitable donations (Fombrun, 1996, for reputation; Galaskiewicz, 1985, for legitimacy), and size (Baum and Oliver, 1991, for legitimacy; Fombrun and Shanley, 1990, for reputation). Symbolic action and impression management may also affect legitimacy and reputation (Ashforth and Gibbs, 1990; Bromley, 1993; Brown, 1994; Dutton and Dukerich, 1991). Our review of research, however, suggests two critical antecedents that may distinguish legitimacy and reputation – isomorphism and financial performance. In developing propositions about individual organizations within an industry and organizational field, we assume the industry itself (e.g. tobacco, Ashforth and Gibbs, 1990) or the organizational form (e.g. conglomerate form, Davis et al., 1994) is not subject to legitimacy challenges.

Isomorphism is a central and multifaceted concept of institutional theory (DiMaggio and Powell, 1983; Meyer and Rowan, 1977). The facet we use is as a state concept at the organizational level, indicating the extent to which an organization is mimetic (i.e. similar) on certain attribute(s) to other organizations in an organizational field. ‘Institutional isomorphism is manifested empirically as increased conformity’, according to Westphal et al. (1997, p. 371). Isomorphism is binary for some attributes, such as whether a municipality has adopted civil service reform (Tolbert and Zucker, 1983). Isomorphism can become more fine-grained for other attributes, such as scholarly content (Kraatz and Zajac, 1996;
Levitt and Nass, 1989), legal contracts (Suchman, 1994), strategies (Deephouse, 1996; Haveman, 1993), or a set of discrete choices like hospital quality practices (Westphal et al., 1997).

A fundamental proposition of institutional theory is that isomorphism leads to legitimacy (DiMaggio and Powell, 1983; Meyer and Rowan, 1977). Organizations conforming to commonly used strategies, structures, and practices appear rational and prudent to the social system and, therefore, are generally considered acceptable (Fligstein, 1991; Tolbert and Zucker, 1983). These commonly used strategies, structures, and practices often emerge from the interactions of organizations within an industry or field and other stakeholders (Edelman, 1992). They may also be imposed by powerful entities like the state, implying strong incentives to conform (Scott, 1995). Conversely, organizations that deviate from normal behaviour violate cultural or legal expectations and theories of organizing. They are subject to legitimacy challenges and may be deemed unacceptable by stakeholders (Hirsch and Andrews, 1984; Meyer and Rowan, 1977; Meyer and Scott, 1983; Stjernberg and Philips, 1993). Organizational level research found that isomorphism on different attributes (e.g. strategies, missions, TQM practices) has a positive effect on different types of legitimacy (e.g. regulative, normative) (Deephouse, 1996; Ruef and Scott, 1998; Westphal et al., 1997). Thus:

**Proposition 1**: Isomorphism is positively related to legitimacy.

The literature has been quite quiet about the effect of isomorphism on reputation at the organizational level. One might expect that some level of conformity to social norms would be necessary in order to develop a favourable reputation, yet gaining a favourable reputation implies that differentiation is also necessary. According to Fombrun (1996, p. 393), ‘The more a company pursues a strategy that differentiates it from rivals with each of its major constituent groups, the more likely are constituents to ascribe a strong reputation to the company . . .’ So it appears that while conformity through isomorphism will likely lead to legitimacy, further efforts at differentiation may be necessary to achieve higher levels of reputation. Thus, isomorphic behaviour may have a different outcome on reputation than it has on legitimacy.

While scholars have been quiet on the relationship between isomorphism and reputation, over the last fifty years there were spates of research by sociologists and social psychologists studying the similar concepts of conformity and status (for a review, see Phillips and Zuckerman, 2001). A relevant finding from this research is that conformity is differentially related to status based on where the actor is located within the status hierarchy. In particular, an enduring legacy is the concept of ‘idiosyncrasy credits’, coined by Hollander (1958), which refers to the ability of high status actors to deviate from group norms without penalty.
In a study of law and investment firms, Phillips and Zuckerman (2001) found that low and high status actors were more likely to adopt non-conforming practices, but for different reasons; middle-status actors were most likely to conform. While Phillips and Zuckerman (2001, p. 383) focused on the effect of status on conformity, they acknowledged that their ‘two ideal-typical phases’ of conformity and evaluation ‘are temporally intertwined’. Indeed, past research also examined how conformity affects status (e.g. Ridgeway, 1981). Consistent with our goal of highlighting differences between legitimacy and reputation, we found it useful to specify isomorphism as an antecedent of reputation to parallel its relationship to legitimacy. We follow the reasoning of Phillips and Zuckerman (2001) and consider different relations for middle, high and low status actors.

Middle status actors conform because they seek to maintain their status. Deviation is viewed by constituents as questionable and unusual and therefore is more likely to lower the actor’s status than to raise it (Phillips and Zuckerman, 2001). Thus, we expect a positive relationship between isomorphism and reputation for middle status actors.

Higher status organizations are more secure in their roles than are middle or lower status organizations. This gives idiosyncrasy credits that allow them to exhibit non-conforming behaviour (Ashforth and Gibbs, 1990; Hollander, 1958; Phillips and Zuckerman, 2001). Constituents may even judge such non-isomorphic actions positively. Indeed, social psychology research indicates that non-conformity by high status actors may in fact enhance their status (Berkowitz and Macaulay, 1961). Thus, there may be a negative relationship between isomorphic behaviour and reputation among higher status firms.

Our expectation for low status organizations differs from that of Phillips and Zuckerman (2001) because our boundary conditions differ. They assumed that low status actors resign themselves to their low status and thus do not concern themselves with the implications of deviation. Phillips and Zuckerman (2001) also assumed actors have the option to move to alternative contexts (interfaces, in their paper). We propose these may not hold in some settings. For instance, regulatory rules in our empirical context, the commercial banking industry, limited alternatives, and deviation could result in closure by regulators (Spong, 1990). In this case, lower status organizations have ‘little choice but to redouble their efforts to signal membership through greater conformity’ (Phillips and Zuckerman, 2001, p. 389), with the intention of moving into the middle or high status. Some low status organizations may raise their status by conforming to industry practices, consistent with mimetic behaviour resulting from problemistic search (Cyert and March, 1963; Haveman, 1993). Moreover, we expect this isomorphic behaviour to be viewed positively by constituents. Thus, we expect a positive relationship between isomorphism and reputation for lower status organizations within our context.
Taken together, these arguments suggest that an organization’s isomorphic actions will be interpreted differently by constituents depending on the organization’s reputation. Thus:

*Proposition 2*: For organizations with lower reputations, isomorphism is positively related to reputation. For organizations with better reputations, isomorphism is negatively related to reputation.

**Differences in Antecedents: Financial Performance**

Financial performance has been linked to legitimacy and reputation as both an antecedent and an outcome. We focus on financial performance as an antecedent. Society expects for-profit business organizations to convert inputs efficiently into goods and services and to have concomitant financial outcomes; legitimacy accrues to those organizations that do (Czarniawska-Joerges, 1989; Dowling and Pfeffer, 1975). Because financial performance is an indicator of efficiency and success, it should be related in some way to legitimacy. The issue for assessing its relative impact on legitimacy is whether financial performance is sufficiently low that questions are asked about the company’s existence (Meyer and Scott, 1983). According to Hirsch and Andrews (1984, pp. 173–4):

Performance challenges [to legitimacy] occur when organizations are perceived by relevant actors as having failed to execute the purpose for which they are chartered and claim support. The values they serve are not at issue, but rather their performance in ‘delivering the goods’ and meeting the goals of their mission are called into question. [A performance challenge] places the target in an inherently more unstable situation than is addressed in a comparative or longitudinal examination of administrative efficiency.

Such challenges may restrict market access (Brown, 1994, 1998; Phillips and Zuckerman, 2001), especially when originating from organizations with coercive power (Stinchcombe, 1968; Weber, 1968). For instance, a company approaching bankruptcy becomes increasingly controlled by governmental regulations designed to stabilize the business.

This observation suggests that normal fluctuations in performance are likely not the basis of changes in legitimacy for firms meeting financial expectations. For example, a for-profit business that reports a lower quarterly profit is not necessarily viewed as less legitimate. Although the firm may not have met the expectations of certain stakeholders who benefit, such as investors, it will not be perceived as any less qualified to remain in business. Also, two firms that are identical, except that one’s financial performance is 5.1 per cent and the other’s is 5.0 per cent,
would likely have no difference in legitimacy. Consideration of the organizational life cycle is also needed; start-up firms typically lose money but are not concomitantly considered illegitimate.

Taken together, these arguments suggest that financial performance has different effects on legitimacy:

**Proposition 3:** For organizations with lower levels of financial performance, financial performance is positively related to legitimacy. For organizations with higher levels of financial performance, there is no relationship between financial performance and legitimacy.

In contrast to our proposition for legitimacy, we expect a positive relationship between financial performance and reputation at all performance levels based on past research. Superior financial performance predisposes stakeholders to assess an organization more favourably (Fombrun and Shanley, 1990). It indicates the organization’s ability to satisfy the self-interests of its exchange partners, such as investors, employees, and customers, and enhances expectations that the firm will continue to do so (Fombrun, 1996). Indeed, researchers found that financial performance is a crucial, even overwhelming, determinant of corporate reputation (Fombrun and Shanley, 1990; Sobol and Farrelly, 1988). The effect of performance on reputation has been found not just for financial performance but also for other aspects of performance. The philanthropic elite of Minneapolis-Saint Paul viewed companies as more generous donors and as successful businesses if they donated more to charity and were more profitable, respectively (Galaskiewicz, 1995). Scientific accomplishment was positively related to status in the nuclear waste and photovoltaic research communities (Shrum and Wuthnow, 1988). Thus:

**Proposition 4:** Higher financial performance is positively related to reputation.

**METHODS**

We test these propositions using data from the population of commercial banks in the Minneapolis-Saint Paul Metropolitan Area, USA (Twin Cities, hereafter) during 1985 to 1992. Commercial banking is an appropriate setting to test our propositions because the industry faces strong institutional and competitive pressures, which means that legitimacy and reputation are important (Scott and Meyer, 1991; Weigelt and Camerer, 1988). Studying a single population in a single metropolitan area controls for differences in industries and community norms. Twin Cities commercial banks are in an organizational field with common suppliers, consumers, and regulators (DiMaggio and Powell, 1983, p. 148). The sample of banks and relevant financial data were collected from the Call Reports database of bank regulators. The unit of analysis is the bank-year.
There were several notable competitive and institutional issues in the Twin Cities commercial banking market. One competitive issue was consolidation within the metropolitan area subsequent to changes in state banking law. A second was that the Twin Cities economy did not have as severe a recession as other parts of the country and was thus spared a large number of bank closures. An important institutional issue was banking for underserved neighbourhoods. Late in the sample period, regulators were mandated by Congress to make public their evaluations of how each bank was responding to this issue (i.e. CRA ratings). These issues are reflected in our study’s measures.

**Dependent Variables**

Legitimacy and reputation are complex, multidimensional concepts linked to a variety of stakeholders. An ideal study would have sufficient resources to measure all dimensions. From a pragmatic perspective, we followed Fombrun (1996) and Ruef and Scott (1998) and limit our research design to certain dimensions (cf. Sudman, 1976). We created measures of regulative legitimacy from the perspective of bank regulators, normative legitimacy from the perspective of the general public, financial reputation from the perspective of bank customers and rating agencies, and normative reputation from the perspective of the general public (Fombrun, 1996; Scott, 1995). Our use of financial information to create legitimacy and reputation measures is consistent with research indicating that stakeholders use financial information in making these assessments about for-profit organizations (Fombrun, 1996; Hirsch and Andrews, 1984). And as described below, it is consistent with the practices used by regulators, rating agencies, and customers themselves. It is also analogous to how health care stakeholders use mortality rates and other health care performance indicators to evaluate hospitals (Health Grades Inc., 2002). The community is an important stakeholder, and its norms and values are important criteria for evaluating legitimacy and reputation (Fombrun, 1996; Suchman, 1995). We used media data to capture the perspective of the general public. As elaborated below, the sample used for the community stakeholder differs from the sample used for the regulatory and financial stakeholders because of data availability and resource constraints (Sudman, 1976).

*Financial regulatory legitimacy.* Regulative legitimacy reflects the conformity of organizational action to regulatory standards and has been measured using government reports (e.g. Baum and Oliver, 1991; Deephouse, 1996; Singh et al., 1986). In banking, the safety and soundness of the financial system and the protection of consumers’ deposits are central concerns of US regulators (Spong, 1985). An important tool used by regulators is the evaluation of a bank’s capital position, which reflects the bank’s ability to protect depositor savings. We used the federal government’s regulatory ratings to measure regulative legitimacy. During 1985–88,
regulators classified banks into three discrete ordered categories, based on their total capital ratio and their size, as presented in Appendix A (Spong, 1985). Regulators labelled banks in the highest category ‘adequately capitalized’; banks in the intermediate category were considered ‘minimally capitalized’; and banks in the lowest category were considered ‘undercapitalized’. We created a variable called financial regulatory legitimacy by numbering the categories 0, 1, and 2, with 2 representing adequately capitalized. For 1989–92, US regulators changed their classification scheme. Combined with an improvement in regional business conditions, no banks in the Twin Cities area had substandard capital levels during this later period (although other banks in the USA did). We could not statistically test regulative legitimacy during the second half of our sample period because there was no variation in the dependent variable. Thus, our sample consisted of 154 banks over four years. After accounting for entries and exits, there were 553 observations.

This regulatory classification is consistent with the conceptual distinctions raised earlier. Regulators’ use of the term ‘adequately’ fits with the view of legitimacy as being acceptable or qualified (Brown, 1994; Lawrence, 1998). For banks in the two lower categories, regulators would increase their supervisory oversight. This included restricting banks’ fundamental business decisions, such as borrowing, lending, and acquisitions; it also included replacing bank employees, especially top managers (Spong, 1985). Thus, increased regulatory supervision is also consistent with theory. As a legitimacy challenge, it limits unfettered access to markets and could lead to closure of a business by powerful entities (Brown, 1994, 1998; Hirsch and Andrews, 1984; Stinchcombe, 1968).

Financial reputation. We measured financial reputation for the same sample to facilitate comparison between legitimacy and reputation. Regulators do not make reputational distinctions for bank safety and soundness. Nevertheless, many bank customers seek more detailed information about the relative safety of individual banks. Even ‘small businesses are worried about the stability of the banks they deal with’ because many have deposits in excess of that covered by government deposit insurance (Valvo, 1988, p. 1). The growing number of bank failures heightened customer interest in monitoring banks (Maloney, 1990; Valvo, 1988). Although regulators have complex on-site examinations of banks, the results are not released to the public, a policy that is sometimes challenged (e.g. Scott et al., 1991). In this context, an industry of bank rating agencies developed to evaluate banks’ financial stability, consistent with the general development of specialized intermediaries that evaluate the reputation of complex organizations (Fombrun, 1996). More than a dozen agencies existed in our sample period, including Duff and Phelps, Sheshunoff, and Veribanc. These agencies analysed banks’ Call Report data, interviewed bank management, and provided user-friendly analyses to paying clients. Their evaluation systems are trade secrets and ratings are expensive to obtain,
especially given the number of active rating agencies. Only the largest US banks are rated by agencies that interview management, given the costs, whereas agencies that use only quantitative analysis examine all banks (Kraus, 1998). Our sample included mostly smaller banks.

Given these factors, we sought a proxy for financial reputation (Sudman, 1976). Maloney (1990) reviewed the industry and interviewed representatives of six rating agencies. The three that used quantitative models reported that asset quality was the most important factor in their models. Asset quality indicates the proportion of bank loans on which customers are paying interest (Maloney, 1990). One agency, Sheshunoff, selected asset quality because its surveys indicated that bankers themselves ranked asset quality as most important. Locher (1992) and Valvo (1988) recommended that small businesses use asset quality to reduce their search costs of finding a quality bank. In other words, asset quality functions as a reputational signal (Weigelt and Camerer, 1988). Higher levels indicate that a bank has a higher quality loan portfolio and is therefore more financially stable than a bank with lower levels. In sum, we measured financial reputation using the following asset quality ratio calculated from the Call Report data.

\[
\text{Financial reputation} = 1 - \left( \frac{\text{Allowance for loan and lease losses} + \text{Loans 90 days overdue} + \text{Loans not accruing}}{\text{Total Equity}} \right)
\]

We measured financial reputation for the entire period 1985–92. Because of our interest in comparing this measure with financial regulatory legitimacy, our results report only the analyses for the 553 observations during 1985–88. Results for the remaining period were similar.

**Public legitimacy.** Normative (or moral) legitimacy reflects the consistency of organizational action with social norms and values (Parsons, 1960; Suchman, 1995). Dowling and Pfeffer (1975, pp. 124–5) wrote that norms and values are reflected in the communications and writings of a society. Also, media research found a close alignment between media content and public opinion as part of the agenda-setting and framing paradigms, with most research indicating the media are active participants in the social construction processes of the public (Ader, 1995; Gamson et al., 1992; McCombs and Shaw, 1972). Thus, we followed past research and measured normative legitimacy using content analysis of media data (Barron, 1998; Brown and Deegan, 1998; Davis et al., 1994; Deephouse, 1996; Lamertz and Baum, 1998). We call our measure *public legitimacy* to distinguish it from measures of normative legitimacy based on professional endorsements (e.g. Ruef and Scott, 1998). We limited our sample period for this measure to 1988–92 for two reasons. First, a change in state banking regulations allowed the area’s bank holding companies to consolidate their independent branch banking units as of December 1987. Media coverage before 1988 was not specific enough to identify
a particular bank. Second, we sought greater coding accuracy within resource constraints by selecting more articles in fewer years and coding the full text of each article (Sudman, 1976; Weber, 1990).

The local print media was selected because past research suggested it best covers local businesses. Newspapers had a stronger effect than television in setting the public’s agenda for local issues (Palmgreen and Clarke, 1977). A nationwide survey found that that 67.3 per cent of the respondents got their news about local businesses from the local newspaper; every other source scored less than 27.1 per cent (Stempel, 1991). Recall is stronger from newspaper stories (DeFleur et al., 1992), which increases the likelihood that stakeholders will take action to support or challenge a bank (Fiske and Taylor, 1984; Schramm, 1949). Thus, local newspapers should be the best media source of public knowledge, values, and opinions about local banks. The specific newspapers chosen were the Minneapolis Star Tribune and the Saint Paul Pioneer Press, the two metropolitan dailies having the largest circulations in the area.

The sample of articles consisted of all letters to the editor, all editorials, all columns, and a stratified sample of the remaining articles. All letters, editorials, and columns were included because they represent interpretations of firms that are overt attempts to influence attitudes (Fombrun and Shanley, 1990; Hynds, 1989, 1994). A two-step process was used to select the remaining articles. All articles were selected for each bank that had fewer than eight articles in a year to increase accuracy. For the rest, a total of eight plus 25 per cent of the remaining number of articles was randomly selected. In total, this sampling procedure yielded 1277 articles.

Coding the articles entailed identifying and rating recording units (Weber, 1990). A recording unit was defined as the evaluation of an individual bank in a single article in terms of its legitimacy. Because many articles mention several banks, 2071 recording units were identified. Only 275 (13.3 per cent) were from letters, editorials, and columns; the rest (86.7 per cent) were from news articles. Each recording unit was given equal weight in the analysis, consistent with past research (Brown and Deegan, 1998; Dickson, 1992).

To measure public legitimacy, each recording unit was rated as either endorsing the bank or questioning its legitimacy, consistent with our earlier review (Hirsch and Andrews, 1984; Meyer and Scott, 1983; Pfieffer and Salancik, 1978). A recording unit was rated as questioning when there was evidence that the bank’s action, structure, mission, or performance was being questioned or challenged. Otherwise, the recording unit was rated as endorsing the bank.

Annual measures for each bank were created using the Janis-Fadner coefficient of imbalance (Coombs, 1992; Janis and Fadner, 1965). As implemented here, this measures the relative number of endorsing (e) and questioning (q) codes in a given year. Its formula is:
The range of this variable is \((-1, 1)\), where 1 indicates all endorsing coverage, \(-1\) indicates all questioning coverage, and 0 indicates a balance between the two.\(^{[1]}\)

One author read and coded full text versions of all sampled articles. A colleague was instructed to use the same coding scheme on 23 per cent (52) of the articles from one year. The two raters agreed on 68 of the 71 recording units (95.8 per cent), suggesting high levels of intercoder reliability (Weber, 1990).

Our sample size for analysing this dependent variable totalled 265, consisting of 96 different banks over 1988–92. Not all banks had media coverage each year. We address the statistical problem this raises below.

Public reputation. Normative reputation represents the extent to which an organization is viewed as better than other organizations in terms of societal norms and values. We again use the media to measure public norms and values for reasons similar to those for measuring public legitimacy. Communication research indicates a close alignment between media content and public opinion (Ader, 1995; Gamson et al., 1992; McCombs and Shaw, 1972). Past reputation research used the media to measure reputation (e.g. Deephouse, 2000; Dutton and Dukerich, 1991), given the media circulate reputational information among stakeholders (Fombrun, 1996). Moreover, the media has been important in creating the reputations of organizations of all types, including the well known rankings of businesses (e.g. the *Fortune* ratings) and business schools published by different media outlets (Elsbach and Kramer, 1996; Fombrun, 1998). We call our variable *public reputation*.

We used the same sample of articles used to measure public legitimacy but applied a different coding scheme. Although one might question the appropriateness of measuring the two concepts from the same media sample, our approach is analogous to having a sample of individuals answering a survey that measures more than one concept, such as job satisfaction and self-efficacy. That is, we follow past textual research that derived multiple themes and relationships from a particular text or set of texts, such as propaganda (Lasswell et al., 1965) or news and discussion about industrial accidents (Gephart, 1993).

We measured public reputation as follows. First, each recording unit was rated as positive, negative, or neutral, following Dominick’s (1981) study of network news coverage of business. A recording unit was rated positive when a bank was praised for its actions or associated with actions that past research indicated should increase a firm’s reputation. Examples of the latter include: awards given to the

The range of this variable is \((-1, 1)\), where 1 indicates all endorsing coverage, \(-1\) indicates all questioning coverage, and 0 indicates a balance between the two.\(^{[1]}\)
bank or its employees (Fombrun, 1996); monetary or in-kind donations (Fombrun and Shanley, 1990); and director linkages to other organizations (Weigelt and Camerer, 1988). A negative rating was given when a bank was criticized for its actions or was associated with actions that past research indicated should decrease a firm’s reputation. There were few of the latter, except for legal or regulatory charges. More often, an author or source criticized a bank’s actions. The essence of a neutral rating was the reporting of role performance without evaluative modifiers. Essential roles for banks included lending, holding deposits, purchasing from suppliers, trying to expand market share, etc. This rating was also given when there was a balance of positive and negative reporting.

Annual measures for each bank were created using the Janis-Fadner coefficient (Coombs, 1992; Janis and Fadner, 1965). As implemented here, this measures the relative number of positive (p) and negative (n) codes in a given year. Its formula is:

\[
\text{Public reputation} = \begin{cases} 
(p**2 - pn)/(total)**2 & \text{if } p > n; \\
0 & \text{if } p = n; \\
(pn - n**2)/(total)**2 & \text{if } u > f.
\end{cases}
\]

The range of this variable is (−1, 1), where 1 indicates all positive coverage, −1 indicates all negative coverage, and 0 indicates a balance between the two.\(^2\)

One author read and coded full text versions of all sampled articles. The aforementioned colleague also coded the sample for reputation. The two raters agreed on 65 of the 71 recording units (91.5 per cent). A second colleague coded 30 articles from a different year, and the two raters agreed on 83.3 per cent of the codes. Together, these results suggest high levels of intercoder reliability (Weber, 1990).

**Independent Variables**

*Strategic isomorphism.* As noted above, past research has examined isomorphism on many organizational attributes, such as strategies, structures, and practices (Deephouse, 1996; Edelman, 1992; Fligstein, 1985, 1991). As with legitimacy and reputation, most empirical research focused on one attribute to limit the research design. We focus on strategy because of its central importance to for-profit businesses, an important sector for the application of institutional theory (Powell, 1991; Scott, 1994, 1995). Moreover, we follow configurational perspectives and assume that strategy, structure, processes, culture, etc., are generally complementary (Meyer et al., 1993; Miller, 1981). Strategy is a concrete instantiation of an organization’s ‘central orchestrating theme’ (Miller, 1996) and may be linked to its interpretive scheme (Greenwood and Hinings, 1988; Ranson et al., 1980). Put another way, a company’s position in its product market is fundamentally related to its perspective in viewing the world (Mintzberg, 1987). For instance, a ‘prospec-
“tor’ may have an innovative culture that supports its exploratory product market approach (Miles et al., 1978).

Bank strategies were measured using bank asset allocations, the commitment of resources to certain product markets (Chandler, 1962; Santomero, 1984). Each allocation is measured as a proportion of total assets. For example, the commercial lending allocation is measured as the proportion of assets that a bank commits to commercial loans. Eleven bank asset allocations were included here: commercial loans, real estate loans, loans to individuals, agriculture loans, other loans and leases, cash, overnight money, securities, trading accounts, fixed assets, and other assets. Reger et al. (1992), Haveman (1993) and Swamy et al. (1996) used similar categories to measure the strategies of banks and thrifts.

We computed the strategic isomorphism of a bank with strategic conformity, which measures the extent to which an organization’s strategies resemble conventional strategies in an industry (Finkelstein and Hambrick, 1990). Each bank’s asset strategy was compared to the industry mean value for that strategy and expressed as a standard deviation. Because strategy is viewed holistically (Mintzberg, 1978), the absolute values of the standard deviations for all the asset allocation variables were totalled for each bank to produce a holistic and parsimonious measure. Multiplying by –1 created a scale for which more positive values indicated greater isomorphism to strategic norms. This measurement procedure is consistent with institutional theory. DiMaggio and Powell (1983) and Scott (1995) suggested that standard deviations may proxy isomorphism to institutional norms. Suchman (1994) used standardized scores to measure isomorphism of legal contracts in Silicon Valley.

Financial performance. We measured financial performance using return on assets (ROA) because it was the most commonly used and well-regarded measure during our sample period (e.g. Gilbert, 1984; Mehra, 1996; Swamy et al., 1996). Reger et al. (1992, p. 195) stated: ‘Return on assets is the most meaningful financial indicator in the banking industry and is the indicator most closely watched by bank analysts and the bankers themselves.’ ROA measures the effectiveness of management’s utilization of its assets and allows comparison between banks with different capital structures (Kidwell and Peterson, 1990). ROA is especially appropriate for our sample because most banks were privately held so no stock market performance measures were available. We computed ROA as the ratio of net income to total average assets. Total average assets was the denominator, consistent with bank regulatory practice, because banks undertake ‘window dressing’ of their balance sheets at year-end and assets change over time.

Control Variables

Theory suggests that age and size may be positively related to both legitimacy and reputation. Although empirical evidence is mixed, we include these as control vari-
ables. The length of time that an organization has been in business may be positively related to both legitimacy and reputation (Aldrich and Auster, 1986; Baldi, 1997; Hannan and Freeman, 1984; Stinchcombe, 1965). Older organizations have established roles, a history of successful accomplishments, and are more deeply embedded in networks of economic and social relationships. A bank's age was measured by subtracting the observation year by the bank’s founding year obtained from *Polk’s Bank Directory*, a standard bank reference. Larger organizations usually have more contractual and social ties to stakeholders, which increases their visibility, status, and taken-for-grantedness (Fombrun and Shanley, 1990; Meyer and Rowan, 1977; Meznar and Nigh, 1995; Phillips and Zuckerman, 2001). Bank size was measured using total average assets from the Call Reports. Average assets, number of employees, and market share are all correlated in excess of 0.93 in this sample.

**Data Analysis**

The propositions were tested using the following general statistical models.

\[
\text{Legitimacy} = b_0 + b_1 \text{* Strategic isomorphism} + b_2 \text{* ROA} + b_3 \text{* Age} + b_4 \text{* Total assets} + e
\]

\[
\text{Reputation} = c_0 + c_1 \text{* Strategic isomorphism} + c_2 \text{* ROA} + c_3 \text{* Age} + c_4 \text{* Total assets} + e
\]

Because the measurement properties of our dependent variables differ, we use different statistical techniques to estimate these models and test the hypotheses (Greene, 1993). Financial regulatory legitimacy is an ordered categorical variable. It is estimated using probit. Financial reputation is a continuous variable and is estimated using regression. Public legitimacy and public reputation are both censored variables and are estimated using censored regression (i.e. tobit). All data were standardized to allow coefficients to be compared. Goodness of fit tests were run on unstandardized data when necessary. The significance of directional propositions was assessed with one-tailed tests.

Autocorrelation can be an issue in time series data. For our continuous measure of financial reputation, OLS estimates yielded a Durbin-Watson statistic of 1.02. We corrected for autocorrelation using the Yule-Walker method of generalized least squares (GLS); results using maximum likelihood method were consistent. There are no comparable procedures for addressing autocorrelation among censored or categorical dependent variables. Our confidence in the reported results is enhanced because GLS estimates for financial regulatory legitimacy were consistent with the probit estimates.

Another important statistical issue arose when measuring public legitimacy and public reputation. Because not all banks were covered by the newspapers in every
year, there was the possibility of sample selection bias (Heckman, 1979). That is, results based on the banks with media scores may not apply to all the banks in the period, raising generalizability concerns. We applied Heckman’s (1979) two-step procedure to correct for this bias. First, we estimated a dichotomous probit model estimating whether or not a bank had any media coverage. The probit estimates were used to create a variable called the ‘inverse Mills ratio’. We then added this variable to the structural regression models (above) to correct for sample selection bias.

We further investigated our estimates in many ways. The major outcome of our model checking was the deletion of one outlying observation, Suburban National Bank in 1988, from our financial reputation and regulatory legitimacy estimates. In our preliminary OLS estimate of financial reputation, this observation had a studentized deleted residual of 32.7, well in excess of the second highest value of 3.9. A convenient statistical measure was not available for the probit and tobit estimates. Given the similarity of probit, OLS, and GLS estimates for financial regulatory legitimacy, we examined studentized deleted residuals from the OLS and found no major outliers. We relied on the residual plots for the tobit estimates that we also used to check for heteroskedasticity. There were no dramatic irregularities. Collinearity was not a problem for any of the models based on analysis of condition numbers (Belsley et al., 1980).

RESULTS

Table I presents the descriptive statistics and correlations for examining financial regulatory legitimacy and financial reputation during 1985–88. The sample size is 553. The correlation between these two variables is positive ($r = 0.26$) and significant ($p < 0.001$), which is not unexpected given their theoretical similarities. Nevertheless, the bivariate explanatory power is less than 7 per cent (square of $r = 0.26$). ROA is correlated 0.30 and 0.55 with legitimacy and reputation, respectively. In bivariate terms, ROA explains 9 per cent and 30 per cent of the variation. These correlations are all well below the 0.70 commonly used in organizational research to suggest that individual items measure the same concept (Nunnally, 1978).

Table II presents the descriptive statistics and correlations when examining public legitimacy and public reputation during 1988–92. The sample size is 265. The correlation between these two variables is positive ($r = 0.30$) and significant ($p < 0.001$), as expected. Still, the bivariate explanatory power is only 9 per cent. ROA is correlated $-0.03$ (n.s.) and 0.15 ($p < 0.05$) with these measures of legitimacy and reputation, respectively. These results clearly indicate that public legitimacy, public reputation, and ROA are distinct.[3]

Table III presents the probit estimates when financial regulatory legitimacy is the dependent variable. Table IV presents the GLS estimates when financial
reputation is the dependent variable. Table V presents the tobit estimates when public legitimacy and public reputation are the dependent variables. Proposition 1 and 2 focus on isomorphism as a way to distinguish legitimacy and reputation. In Model 1 of Table III, strategic isomorphism has a significantly positive effect on financial regulatory legitimacy ($\beta = 0.203, p < 0.01$). In Model 1 of Table V, strategic isomorphism has a significantly positive effect on public legitimacy ($\beta = 0.067, p < 0.05$). Thus, there is support for Proposition 1.

Proposition 2 predicts a positive relationship between isomorphism and reputation for organizations with lower reputations and a negative relationship for organizations with higher reputations. This suggests that the significant positive relationship between isomorphism and financial reputation for the full sample (Model 1, Table IV) is driven by the positive relationship among banks with lower
### Table III. Probit estimates of financial regulatory legitimacy, 1985–88

<table>
<thead>
<tr>
<th>Independent variables</th>
<th>Model 1</th>
<th>Model 2</th>
<th>Model 3</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Full sample</td>
<td>Lowest 75%</td>
<td>Highest 25%</td>
</tr>
<tr>
<td>Intercept</td>
<td>1.069*** (0.069)</td>
<td>0.908*** (0.073)</td>
<td>2.116*** (0.316)</td>
</tr>
<tr>
<td>Strategic isomorphism</td>
<td>0.203** (0.072)</td>
<td>0.175* (0.082)</td>
<td>-0.044 (0.270)</td>
</tr>
<tr>
<td>ROA</td>
<td>0.326*** (0.062)</td>
<td>0.258*** (0.067)</td>
<td>-0.282 (0.268)</td>
</tr>
<tr>
<td>Age</td>
<td>-0.009 (0.069)</td>
<td>0.041 (0.077)</td>
<td>-0.179 (0.247)</td>
</tr>
<tr>
<td>Total assets</td>
<td>0.101 (0.075)</td>
<td>0.081 (0.087)</td>
<td>-0.780** (0.257)</td>
</tr>
<tr>
<td>Ordinal probit threshold</td>
<td>1.001*** (0.115)</td>
<td>0.971*** (0.116)</td>
<td></td>
</tr>
<tr>
<td>Likelihood ratio statistic</td>
<td>519.5</td>
<td>456.6</td>
<td>35.9</td>
</tr>
<tr>
<td>Total R-squared</td>
<td>553</td>
<td>414</td>
<td>139</td>
</tr>
</tbody>
</table>

Notes: Standardized coefficients reported. Standard errors are in parentheses. The ordinal probit threshold is not reported for Model 3 because there are only two categories for the dependent variable.

*p < 0.05; **p < 0.01; ***p < 0.001.

### Table IV. Generalized least squares estimates for financial reputation, 1985–88

<table>
<thead>
<tr>
<th>Independent variables</th>
<th>Model 1</th>
<th>Model 2</th>
<th>Model 3</th>
<th>Model 4</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Full sample</td>
<td>Reputation</td>
<td>Reputation</td>
<td>Reputation</td>
</tr>
<tr>
<td></td>
<td>lowest quartile</td>
<td>second and third quartile</td>
<td>highest quartile</td>
<td></td>
</tr>
<tr>
<td>Intercept</td>
<td>-0.001 (0.058)</td>
<td>-0.001 (0.083)</td>
<td>-0.001 (0.074)</td>
<td>-0.003 (0.111)</td>
</tr>
<tr>
<td>Strategic isomorphism</td>
<td>0.083* (0.042)</td>
<td>0.160* (0.091)</td>
<td>-0.005 (0.065)</td>
<td>-0.150+ (0.093)</td>
</tr>
<tr>
<td>ROA</td>
<td>0.443*** (0.035)</td>
<td>0.539*** (0.064)</td>
<td>0.062 (0.061)</td>
<td>0.063 (0.093)</td>
</tr>
<tr>
<td>Age</td>
<td>-0.015 (0.045)</td>
<td>0.186* (0.083)</td>
<td>-0.074 (0.068)</td>
<td>-0.047 (0.093)</td>
</tr>
<tr>
<td>Total assets</td>
<td>-0.195*** (0.047)</td>
<td>-0.184 (0.099)</td>
<td>0.089 (0.069)</td>
<td>-0.165 (0.098)</td>
</tr>
<tr>
<td>Sample size</td>
<td>553</td>
<td>138</td>
<td>276</td>
<td>139</td>
</tr>
<tr>
<td>Total R-squared</td>
<td>0.52</td>
<td>0.52</td>
<td>0.07</td>
<td>0.11</td>
</tr>
<tr>
<td>Sum of squared errors</td>
<td>265.6</td>
<td>108.4</td>
<td>13.4</td>
<td>0.6</td>
</tr>
</tbody>
</table>

Notes: Standardized coefficients reported. Standard errors are in parentheses. Sum of squared errors are reported for unstandardized data to avoid adding variance to goodness of fit tests.

*p = 0.054; *p < 0.05; **p < 0.01; ***p < 0.001.
financial reputations. To examine this, we split the sample at different quartiles for the reputation measure. We report in Models 2–4 the division that best informs middle status conformity theory. Model 2 has estimates for the first quartile; the coefficient for strategic isomorphism is significantly positive (p < 0.05). Model 3 has estimates for the intermediate two quartiles; the coefficient for strategic isomorphism is not significantly different from zero (β = -0.005, SE = 0.065, p = 0.94). Model 4 has estimates for the highest quartile; the coefficient for strategic isomorphism is negative and significant at p = 0.054, which is not unreasonable for the sample size of 139. We compared the fit of these sub-samples to the full sample reported in Model 1 using an F-test of structural change (Greene, 1993). Because the GLS transformation alters the R-squared statistics, we calculated the F-statistic using sum of squared errors on unstandardized data. Splitting the sample significantly improved the fit (F(12, 535) = 52.17; p < 0.001). Combined with the pattern of significance for strategic isomorphism noted above, there is support for Proposition 2 for this dimension of reputation.

The same cannot be said for public reputation. Creating split samples with the public reputation measure was problematic given its distribution. Many banks had only neutral coverage in a given year (110 of 265 observations.) Splitting the data at the median or either quartile produced only a modest level of significance for strategic isomorphism in the highest quartile of public reputation (β = -0.172; SE = 0.120, p < 0.10) This negative relationship is consistent with the view that

<table>
<thead>
<tr>
<th>Independent variables</th>
<th>Model 1 Public legitimacy</th>
<th>Model 2 Public reputation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Intercept</td>
<td>1.217***</td>
<td>0.252***</td>
</tr>
<tr>
<td></td>
<td>(0.059)</td>
<td>(0.047)</td>
</tr>
<tr>
<td>Strategic isomorphism</td>
<td>0.067*</td>
<td>0.044</td>
</tr>
<tr>
<td></td>
<td>(0.031)</td>
<td>(0.029)</td>
</tr>
<tr>
<td>ROA</td>
<td>-0.014</td>
<td>0.060*</td>
</tr>
<tr>
<td></td>
<td>(0.037)</td>
<td>(0.027)</td>
</tr>
<tr>
<td>Age</td>
<td>-0.176***</td>
<td>-0.016</td>
</tr>
<tr>
<td></td>
<td>(0.042)</td>
<td>(0.030)</td>
</tr>
<tr>
<td>Size (total assets)</td>
<td>-0.022</td>
<td>-0.016</td>
</tr>
<tr>
<td></td>
<td>(0.034)</td>
<td>(0.033)</td>
</tr>
<tr>
<td>Inverse Mills ratio</td>
<td>0.206**</td>
<td>-0.004</td>
</tr>
<tr>
<td></td>
<td>(0.077)</td>
<td>(0.067)</td>
</tr>
<tr>
<td>Sample size</td>
<td>265</td>
<td>265</td>
</tr>
<tr>
<td>Likelihood ratio statistic</td>
<td>449.6</td>
<td>365.9</td>
</tr>
</tbody>
</table>

Notes: Standardized coefficients reported. Standard errors are in parentheses.
*p < 0.05; **p < 0.01; ***p < 0.001.
deviation by higher status firms may help their reputation. We also divided the sample into upper and lower groups at 0, inclusive, but no significant results were found. Thus, there is minimal support for Proposition 2 connecting strategic isomorphism and public reputation. Nevertheless, this non-significant result does distinguish between public legitimacy and public reputation. Taken together, our results suggest that isomorphism has different relationships with two dimensions of legitimacy and reputation.

We next turn to the effect of financial performance on legitimacy and reputation. Proposition 3 predicts that financial performance has a positive effect on legitimacy for lower levels of performance but no effect for higher levels. To test this, we bifurcated the samples at each quartile of ROA. For financial regulatory legitimacy, ROA is positive and significant for the lowest quartile, half, and three quartiles of the sample. Models 2 and 3 of Table III report our results when splitting at the third quartile. Model 2 shows that ROA is positively associated with financial regulatory legitimacy for banks below the third quartile (p < 0.001), whereas Model 3 shows no relationship between for those firms in the highest quartile. Splitting the sample in this way is a significant improvement over the pooled model. The likelihood ratio test statistic equals 26.92 (χ²(6); p < 0.001), providing support for Proposition 3 on this dimension. Support is not found for the public legitimacy data; no significant results for ROA are found for the whole sample (Model 1, Table V) or within any quartile.[4]

Proposition 4 predicts that financial performance has a positive relationship with reputation. The coefficient for ROA in Model 1 of Table IV is positive and significant. In comparison to its effect on legitimacy, we expected this effect to be present for higher levels of financial performance. Significance when splitting at the third quartile (as reported for legitimacy) is p < 0.001 for the lower three quartiles and p < 0.05 for the highest quartile. For public reputation (Model 2, Table V), ROA is also positively related (ß = 0.060; p < 0.05) for the full sample. Thus, there is support for Proposition 4. Taken together, our results suggest that financial performance has different relationships with two dimensions of legitimacy and reputation.

We also compared the relative effects of financial performance on legitimacy and reputation. Our results indicate that financial performance has a stronger effect on reputation than legitimacy. The testing procedure is fairly complex because of the different measurement properties of the dependent variables. Details are reported in Appendix B.

DISCUSSION

Our starting point is the observation that legitimacy and reputation are receiving increased attention from researchers and practitioners, but there has been little to no attention to clarifying their conceptual differences, an important task in devel-
oping theory (Kaplan, 1964; Stinchcombe, 1968; Wright, 1985). This paper theoretically distinguishes legitimacy and reputation by comparing their definitions and by examining the role of isomorphism and financial performance as antecedents. Empirical support is found for two types of legitimacy and reputation.

Concisely stating the definitional differences between legitimacy and reputation is difficult given their complexity, yet such a statement can provide a basis for future research. Most definitions of legitimacy focused on the social acceptance resulting from adherence to regulative, normative, or cognitive norms that qualify one to exist. In contrast, most definitions of reputation focused on relative comparisons among organizations on various attributes (see especially Lawrence, 1998; Ruef and Scott, 1998; Shenkar and Yuchtman-Yaar, 1997). The ability of these definitions to distinguish the concepts is evident in the moderate correlations between our measures of legitimacy and reputation and the different regression results.

This study also examines how two key antecedents theoretically and empirically differ in their relationship to two dimensions of legitimacy and reputation. Our expectations for isomorphism are by and large met: three of four tests support our propositions and the unsupported test is still indicative of a difference between the two concepts. Consistent with institutional theory and past research, we find that isomorphism is positively related to both dimensions of legitimacy. Our study also sheds light on theories of status and conformity recently discussed by Phillips and Zuckerman (2001). Like them, we find that organizations with the highest reputations are able to deviate from normal strategic behaviour and maintain or improve their status, consistent with Hollander (1958). Our extension to this research examining low status organizations is also supported. We find that in a situation where neighbouring contexts are limited, lower reputation organizations can improve their reputation by imitating the common strategies of the industry. Intermediate quartiles of financial reputation appear to be a transition zone for conformity. These results hold for the financial reputation dimension but not the public reputation dimension, however. Future research could examine if these results hold for other dimensions of reputation or for isomorphism on other organizational attributes.

Our expectations for financial performance as a way to distinguish legitimacy and reputation are also by and large met: three of four propositions are supported and the unsupported test is still indicative of a difference between the two concepts. We extend prior theory by proposing and demonstrating that incrementally superior performance is not always required for obtaining and maintaining legitimacy. Instead, an organization must have performance sufficient to avoid questions and challenges (Hirsch and Andrews, 1984; Meyer and Scott, 1983; Pfeffer and Salancik, 1978). We do not find a relationship between ROA and public legitimacy. Consistent with our results, Westphal et al. (1997) reported that hospital performance did not affect normative legitimacy. We suggest further inquiry into
the relationship between financial performance and normative legitimacy. For reputation, we support past research that found incrementally superior performance improves an organization’s relative reputation (Fombrun and Shanley, 1990).

While our examination shows that similar antecedents have different consequences for the legitimacy and reputation of organizations, future research could examine the degree to which losing legitimacy and/or reputation will interfere with a firm’s ability to operate effectively. Past research indicates that if a firm’s actions or structures do not meet social expectations, a firm can have its legitimacy questioned and challenged, and, in the extreme case, be judged illegitimate (Hirsch and Andrews, 1984; Meyer and Scott, 1983; Pfeffer and Salancik, 1978). Market-oriented organizations facing legitimacy challenges often lose their unrestricted access to markets, limiting strategic choice and perhaps causing them to become non-players in certain markets (Brown, 1994, 1998; Phillips and Zuckerman, 2001). This is especially problematic when legitimacy challenges come from organizations that exercise coercive power or mobilize other social actors (Stinchcombe, 1968; Weber, 1968). For example, a hospital lacking accreditation from the Joint Commission on the Accreditation of Healthcare Organizations cannot participate in the US government’s Medicare programme or many state Medicaid programmes (Ruef and Scott, 1998; Westphal et al., 1997).

In contrast, we suggest that the consequences of a lower reputation are less dire. Being less well regarded than another organization does not threaten the organization’s continued existence as long as the organization’s legitimacy remains unchallenged. The lower status business organization does not lose access to markets, although it might have to reduce its prices to keep its customers (Podolny, 1993). Finally, and perhaps most importantly, having a lower reputation does not necessarily mean the organization will be challenged by the state or the collective action of powerful stakeholders. A case study of a legitimate and highly reputable organization that deviated so far as to lose legitimacy could inform practice and theory. And more generally, a further understanding of the complexities of managing legitimacy and reputation simultaneously should improve an organization’s ability to act in a more effective and informed manner.

While the empirical analysis generally supports our theoretical framework, there are several limitations that warrant inquiry in future research. First, our results may have been affected by the choice of one established industry and the selection of two stakeholder groups, the financial community and the general public. This focus was necessary to ensure that we could observe potential differences between legitimacy and reputation without the complication of multiple industries, dimensions, and stakeholders. Future research could examine if our distinguishing criteria hold in other industries, such as embryonic, declining, or those facing legitimacy challenges (e.g. nuclear power in some countries). Notably, our results may not hold in industries where either competitive or institutional forces
are weak. Moreover, future research could examine other dimensions of legitimacy and reputation. The potency of regulative, normative, and cognitive dimensions may vary by context.

A second limitation is that we measured reputation using a financial ratio because of resource constraints (Sudman, 1976). This ratio was the most important indicator to bank rating agencies (Maloney, 1990) and served as a reputational signal to customers (Locher, 1992; Valvo, 1988). Also, our results are generally as expected. Nevertheless, future research could collect ratings from specialized information intermediaries in this or other industries (Fombrun, 1996).

A third limitation of our study is that each newspaper article received equal weight in constructing our measures of public legitimacy and public reputation, consistent with past research (e.g. Brown and Deegan, 1998; Dickson, 1992). Future research could examine different weighting approaches. Such an inquiry would require theory development in at least two areas (Shoemaker and Reese, 1996). The first, pertaining to media effects, is the relative impact on audiences of different types of articles, such as editorials versus news stories. This could be extended to include position on the front page of a section, the presence of photographs, etc. The second area for theory development, pertaining to media content, is explaining why certain banks get covered in different ways.

A fourth limitation of our study is that we only measured isomorphism using standard deviation units that were equally weighted across all asset categories, following DiMaggio and Powell (1983), Finkelstein and Hambrick (1990), Suchman (1994), and Scott (1995). Different weightings could be used, and we considered some of these in the context of the probit model for financial regulatory legitimacy. One possibility is that deviations on the larger assets (e.g. real estate lending) may be more important because they would be more likely to be noticed. This is not true in our sample. Instead, we found that legitimacy is affected by a lack of isomorphism on smaller asset categories with high coefficients of variation (e.g. trading assets). Consistent with this, Porac et al. (1989) found that most Scottish knitwear firms followed the ‘Hawick Mind’, but the few that added more sporty lines like cotton golf sweaters had questions raised about them. Also, there may be less consensus about the range of acceptable behaviour for smaller, more secondary attributes compared to larger, core attributes (Deephouse, 1999; Lawrence, 1998). Future research could investigate different measures of isomorphism and their possibly differing effects on different types of legitimacy and reputation. The variety of possible empirical approaches necessitates further theoretical development.

A fifth limitation is that strict causality cannot be inferred. Our regression model implies that isomorphism and financial performance influence legitimacy and reputation, following DiMaggio and Powell (1983), Shrum and Wuthnow (1988), and Fombrun and Shanley (1990). To assess the temporal precedence component of causality, we replaced contemporaneous measures of ROA and strategic isomor-
phism with the prior year's measures. Consistent results are found for these smaller samples. Still, the causal direction may be reversed for financial performance, following resource dependence theory (Pfeffer and Salancik, 1978) and the resource-based view of the firm (Hall, 1992). Together, these theories imply more complex relationships among performance, legitimacy, and reputation. Our study cast light on the distinctiveness of legitimacy and reputation that is necessary for examining these more complex relationships (Kaplan, 1964).

To conclude, this paper finds theoretical and empirical support for three key differences between legitimacy and reputation. In terms of definitions, we contrast legitimacy's social acceptance resulting from adherence to regulative, normative and cognitive expectations with reputation's comparisons among organizations on various attributes. Isomorphism appears critical for legitimacy but may have more complex relationships with reputation. Although financial performance is beneficial for both, its benefit for legitimacy may taper off for higher performing firms. Future research can expand upon these distinguishing characteristics and elaborate further differences and relationships between these two important concepts.

NOTES

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[1] We considered using a simpler coefficient, equal to the difference between the number of endorsing and questioning recording units, divided by the total number of recording units. We did not use this measure because the convergence criterion was questionable in the censored regression analyses, the appropriate statistical technique for this type of range restricted variable. Nevertheless, results were consistent with those presented below, which is not surprising given the 0.99 correlation between the two measures.

[2] Similar to public legitimacy, we also tested the simpler ratio of the difference between the number of positive and negative recording units, divided by the total. The two are correlated 0.96, and results are similar. We use the Janis-Fadner coefficient for consistency with public legitimacy.

[3] There are 51 observations in 1988 that have measures of all four dependent variables. Public legitimacy is correlated 0.00 and 0.21 with financial regulatory legitimacy and financial reputation, respectively. Public reputation is correlated 0.13 and 0.33 with financial regulatory legitimacy and financial reputation, respectively. Given the small sample size, only the last correlation is significant (p < 0.05). The magnitudes again indicate that the different measures of legitimacy and reputation are distinct. We note that 47 of 51 observations for financial regulatory legitimacy are in the highest category, with the other four in the intermediate category.

[4] As part of our investigation, we examined if ROA has a stronger relationship with the lowest and intermediate levels of financial regulatory legitimacy than it does with intermediate and highest levels. To avoid double-counting the intermediate category, we divided randomly the intermediate category to estimate the two models. To create statistical tests, we used a bootstrap procedure with 500 iterations (Efron, 1979; Freedman and Peters, 1984). Splitting the sample in this way is superior to the pooled model (LR = 226.4, chi-squared (4), p < 0.001). Moreover, although both ROA coefficients are significantly positive, the coefficient for the lower legitimacy
group is significantly greater at p < 0.08 (Δβ = 0.503 − 0.149 = 0.354, SE(Δβ) = 0.250; t = 1.42, n = 51, conservatively using the smaller sample size). Thus, financial performance may be less important as legitimacy increases.

APPENDIX A

Measure of Financial Regulatory Legitimacy

Total capital ratio = \((\text{Total equity capital} + \text{limited life preferred stock} + \text{subordinated notes and debentures} + \text{minority interests in consolidated subsidiaries} + \text{allowance for loan and lease losses})/(\text{Total assets} + \text{allowance for loan and lease losses})\).

Categories of Financial Regulatory Legitimacy

2 = Banks with a total capital ratio greater than 7.0% and total average assets less than $1 billion.

<OR>

Banks with a total capital ratio greater than 6.5% and total average assets of $1 billion or more.

1 = Banks with a total capital ratio between 7.0% and 6.0% inclusive and total average assets less than $1 billion.

<OR>

Banks with a total capital ratio between 6.5% and 5.5% inclusive and total average assets of $1 billion or more.

0 = Banks with a total capital ratio less than 6.0% and total average assets less than $1 billion.

<OR>

Banks with a total capital ratio less than 5.5% and total average assets of $1 billion or more.


APPENDIX B

Comparison of the Effect of Financial Performance on Legitimacy and Reputation

We also investigated the relative effects of financial performance on legitimacy and reputation, suspecting it would more strongly affect reputation than legitimacy. To be seen as legitimate, an organization must have sufficient financial performance to meet societal expectations that qualify it to be an ongoing business organization and avoid questions or performance challenges (Czarniawska-Joerges, 1989; Dowling and Pfeffer, 1975; Hirsch and Andrews, 1984; Lawrence, 1998; Meyer
and Scott, 1983). However, superior financial performance can help to discriminate among firms in determining status hierarchies (Fombrun and Shanley, 1990). Combining this with Suchman’s (1995, pp. 573–4) definition of legitimacy as a ‘generalized perception or assumption’, we infer that stakeholders make less fine-grained evaluations for legitimacy than for reputation.

Testing this requires that the coefficients for ROA be compared between equations 1 and 2. Because some dependent variables have different measurement scales and thus were estimated by different methods, comparing all coefficients is problematic. Past research suggested that using regression in place of probit might not be a serious problem because of the robustness of least squares regression (Labovitz, 1970; Michel and Hambrick, 1992). We assessed this by estimating all models using GLS and comparing the results to the original probit or tobit estimates. For financial regulatory legitimacy, the pattern of significance for the GLS estimate was similar to the probit estimate. The GLS estimates for public legitimacy and public reputation were not consistent with the tobit estimates, however, so we did not directly compare the financial-regulatory and normative dimensions.

To enhance our comparisons, we created a categorical variable from the sorted financial reputation variable that has the exact same distribution as the financial regulatory legitimacy variable. Probit estimates for this were similar to the GLS estimates, so we also compared the probit coefficients for ROA. Similar patterns were found when splitting the sample at the 75th percentile of ROA. Goodness of fit tests (available from the authors) show that pooling the data for each estimator significantly reduced model fit, indicating that financial regulatory legitimacy and financial reputation behave differently.

We tested the differences statistically using a Wald test (Greene, 1993; Judge et al., 1985). Table AI presents our comparison of coefficients for ROA when financial regulatory legitimacy and financial reputation were dependent variables. In all cases, the coefficients for ROA are significantly larger when financial reputation was the dependent variable. Significance levels are less than 0.01 for the full sample and the lowest three quartiles of ROA. With the 139 observations with the highest ROA, the significance levels are still 0.02 and 0.05. The ROA coefficients for public legitimacy and public reputation are reported in Table V. The ROA coefficient for public reputation exceeds the ROA coefficient for public legitimacy by 0.074, which is significant (Wald $t = 1.61, p < 0.05$).
Table AI. Comparison of ROA coefficients between financial reputation and financial regulatory legitimacy

<table>
<thead>
<tr>
<th></th>
<th>Full sample, N = 553</th>
<th>Lowest 75%, N = 414</th>
<th>Highest 25%, N = 139</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Coefficient</td>
<td>Standard error</td>
<td>Coefficient</td>
</tr>
<tr>
<td><strong>GLS estimates</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Financial reputation</td>
<td>0.445</td>
<td>0.035</td>
<td>0.448</td>
</tr>
<tr>
<td>Financial regulatory</td>
<td>0.265</td>
<td>0.044</td>
<td>0.233</td>
</tr>
<tr>
<td>legitimacy</td>
<td>t-statistic</td>
<td>3.202****</td>
<td>3.380***</td>
</tr>
<tr>
<td><strong>Probit estimates</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Financial reputation</td>
<td>0.571</td>
<td>0.067</td>
<td>0.578</td>
</tr>
<tr>
<td>Financial regulatory</td>
<td>0.326</td>
<td>0.062</td>
<td>0.258</td>
</tr>
<tr>
<td>legitimacy</td>
<td>t-statistic</td>
<td>2.701**</td>
<td>3.230***</td>
</tr>
</tbody>
</table>

Notes: Wald test: Hypothesis: $b_{Rep/ROA} - b_{Leg/ROA} > 0$.
Test statistic: $t = (b_{Rep/ROA} - b_{Leg/ROA}) / \sqrt{S.E.(b_{Rep/ROA})^2 + S.E.(b_{Leg/ROA})^2}$.
t has N–K degrees of freedom.

*p < 0.05; **p < 0.01; ***p < 0.001.

REFERENCES


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