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Universidad Carlos III de Madrid
Calle Madrid, 126
28903 Getafe (Spain)
Fax (34-91) 6249608

CORPORATE ETHICAL IDENTITY AS DETERMINANT OF FIRM PERFORMANCE: A TEST OF THE MEDIATING ROLE OF STAKEHOLDER SATISFACTION

Pascual Berrone [*1], Jordi Surroca[2] and Josep A. Tribó[3]

Abstract

In this article, we empirically assess the impact of the Corporate Ethical Identity (CEI) on the firm's financial performance. Drawing on formulation of both normative and instrumental stakeholder theory, we argue that firms with a strong ethical identity achieve greater degree of stakeholder satisfaction, which in turn, positively influence the firms' financial performance. We further analyze two different dimensions of the CEI of firms: *corporate revealed ethics* and *corporate applied ethics*. Our results indicate that while revealed ethics has informational worth and enhance shareholder value, applied ethics has a positive impact through the improvement of stakeholder satisfaction. However, revealed ethics by itself (i.e. decoupled from ethical initiatives) is not sufficient to boost economic performance.

Key words: business ethics, economic performance, corporate ethical identity, stakeholder satisfaction, stakeholder theory.

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[*1] Corresponding author Universidad Carlos III de Madrid. Department of Business Administration. Calle Madrid 126. Office 6.26. Getafe (28903) Madrid – Spain. (34) 91-6249892 (phone). (34) 91-6249607 (fax). E-mail: pascual.berrone@uc3m.es
[2] Universidad Carlos III de Madrid. Department of Business Administration. Calle Madrid 126. Office 6.22 Getafe (28903) Madrid – Spain. (34) 91-6248640 (phone). (34) 91-6249607 (fax). E-mail: jsurroca@emp.uc3m.es
[3] Universidad Carlos III de Madrid. Department of Business Administration. Calle Madrid 126. Office 7.32b. Getafe (28903) Madrid – Spain. (34) 91-6249321 (phone). (34) 91-6249607 (fax). E-mail: joatribo@emp.uc3m.es

INTRODUCTION

During the last decades, the ethical behavior of firms and the potential effects of malfeasance on society have drawn the interest of researches and business press. Recently, business ethics have attracted renewed attention due to notorious corporate scandals like those of Enron, Worldcom, Arthur Andersen, Tyco International, and Adelphia. Additionally, the growing importance of governmental regulations, the amplified scrutiny of media, and the increasing pressure from different stakeholders have placed the business ethics challenge on the strategic agenda of virtually all firms (Ponemon and Michaelson, 2000; Stevens et al., 2005; Weaver et al., 1999). Consequently, ethical identity of firms has emerged as another characteristic with an intrinsic value. This is recognized by investors who are increasingly willing to invest in business-ethic funds. In the academic arena, the proliferation of specialized journals like “Journal of Business Ethics” and “Business Ethics Quarterly” is testament of this skyrocketing area of research.

Despite significant contributions in the past, there is still a growing need for answers in the area of business ethics and social responsibility of the firm (Donalson, 2003; Harrison and Freeman, 1999; Walsh et al., 2003). The knowledge about the existing linkages between the ethical stance of firms and organizational dimensions remains limited at best. At least two reasons exist for this lack of answers. First, there are encountered theoretical positions on the effect of business ethics and good corporate behavior on performance. While some authors (Hosmer, 1994; Jones, 1995) argue that ethics are good business investment because it generates positive externalities like trust and commitment with relevant stakeholders, which in turn assure long-term performance, others remain skeptical (Friedman, 1970; Jensen, 2001; Schwab, 1996). This latter line of research argues that ethical initiatives are investment without pay-offs and, therefore, are against the shareholder's best interest. The second reason is the limited empirical work addressing corporate ethical issues explicitly, and it has shown mixed results (e.g. Berman et al., 1999; Hillman and Keim, 2001). Thus, the question of whether good ethics leads to good business is still an unresolved issue (Gibson, 2000). In particular, very little is known about how corporate identity regarding ethics may affect the company's results. Regardless the proven importance of corporate identity (Balmer, 1998, 2001; Fombrun, 1996), the ethical component has been largely neglected.

The purpose of this article is to empirically assess the impact of the Corporate Ethical Identity (CEI) on the firm's financial performance. Our work departs from recognizing that ethical claims from different stakeholders shape the firm's ethical identity. Drawing on formulation of both normative and instrumental stakeholder theory, we propose a scheme where the gap between ethics and performance is bridged by the satisfaction of stakeholders. We argue that firms with a strong ethical identity achieve greater degree of stakeholder satisfaction, which in turn, positively affects the firms' financial performance. We further analyze two different dimensions of the CEI of firms: *corporate revealed ethics* and *corporate applied ethics*. Our results indicate that each of these components has differentiating importance. While revealed ethics has informational worth and enhance shareholders value, applied ethics has a positive impact through the improvement of stakeholder satisfaction. However, revealed ethics by itself (i.e. decoupled from ethical initiatives) is not sufficient to boost economic performance.

Several contributions can be distinguished from our work. First, we propose the concept of Corporate Ethical Identity, enhancing the corporate identity research. Traditionally, the concept of corporate identity has been equated with graphics designs and visual identification. However, recent research has extended this definition to a broader concept, which draws on organizational behaviors and values (Fombrun, 1996; van Riel and Balmer, 1997). Extending this line, we suggest the notion of Corporate Ethical Identity as an important dimension of the overall corporate personality. Second, we contribute to the business ethics literature by assessing the pattern between the ethical identity of firms, stakeholder satisfaction, and financial performance. We theoretically link the relationship between these concepts and empirically test them, enhancing the limited existing evidence between business ethics and performance. Third, we identify two different dimensions of corporate ethical identity and suggest differentiating effect on stakeholder satisfaction and financial outcomes. This has important implications for both managers and researchers. Last, we extend stakeholder theory by suggesting stakeholder satisfaction as the binding "glue" between the normative and instrumental stakeholder strands.

The rest of the article is structured as follows. First, we define CEI and its dimensions. Next, we present relevant literature akin to the objectives of this work and our theoretical formulation. We propose a set of hypotheses grounded in the logic of stakeholder theory, which analyze the relationship between the impacts of Corporate Ethical Identity on the financial performance of firms. Next, we test our hypotheses on a sample of 515 firms from 26 countries. The article concludes with a discussion of the theoretical and practical significance of the study.

THEORETICAL FRAMEWORK AND HYPOTHESIS

Corporate identity can be defined as the "articulation of what the organization is, what it does and how it does it, and is linked to the way an organization goes about its business and the strategies it adopts" (Markwick and Fill, 1997, p. 397). Corporate identity deals with the essence of the firm and its enduring characteristics: its philosophy, values, history, strategy, business scope, and communication (Balmer, 1998; Scott and Lane, 2000).

Corporate identity is receiving increasing attention by both practitioners and academics alike since it is recognized as a strategic resource and a valuable tool to address the needs of the firm's stakeholders (van Riel, 1995). Indeed, corporate identity emerges from the permanent interactions between the firm and its stakeholders (Scott and Lane, 2000). Stakeholders have interests and demands, and the firm is responsible to coordinate and attend them while serving its strategic needs (Clarkson, 1995). The way firm manages the stakeholder claims contributes to shaping its identity, in that its values, actions, and stance differentiate it from other organizations (Fombrun, 1996; Scott and Lane, 2000).

Not surprisingly, stakeholders have been shown to play a substantial role in defining the ethical stance of the firm. The ethical stance of a firm is constructed based on the expectation of society, that is, the *legitimate* claims made by the constituencies to whom the firm interacts (Logsdon and Yuthas, 1997; Mitchell et al., 1997; Wood, 1991). In the words of Ferrel and colleagues, "whether a specific required behavior is right or wrong, ethical or unethical, is often determined by stakeholders, such as investors, customers, interest groups, employees, the legal system, and the community" (Ferrell et al., 2000, p.6). Recent empirical studies support the previous argument. For instance, Weaver et al. (1999) showed that the orientation of corporate ethics programs reflected both external influences (e.g. institutional environment) and internal pressures (e.g. top management). Ethical endeavors, like ethics programs, bring together the organization's decisions and the societal ethical claims (Weaver et al., 1999). In a similar vein, Stevens and colleagues (2005) found evidence that financial executives are more likely to integrate their firm's ethics code into their strategic decisions if they perceived the pressure from market stakeholders. Together, these studies indicate that ethical actions are responses to the needs and claims of different stakeholders.

As previously argued, the manner the firm handles the stakeholder needs determines its identity. Accordingly, the way a firm responds to the stakeholder *ethical* claims defines its *ethical* identity, which can be considered as a part of the overall corporate identity (Fombrun and Foss, 2004; Fritz et al., 1999; Logsdon and Yuthas, 1997). Therefore, *we define Corporate Ethical Identity (CEI) as the posture a firm takes with respect to the ethical demands and claims of all its stakeholders.* It refers to the goals, values, practices, processes, and actions a firm takes and through which stakeholders consider the organization as ethical.

The corporate identity concept is a multidimensional construct (Melewar and Jenkins, 2002). Previous literature seems to show consensus on two main features that define the way in which identity is made public to internal and external audiences: communications and behaviors (van Riel and Balmer, 1997). The first one refers to the explicit revelation of those aspects of identity like history and values, while the second is related to those activities and actions that shape the corporate identity. Likewise, we identify two different dimensions that define the CEI. The first dimension refers to what we call *Corporate Revealed Ethics* (CRE), and deals with the communication of the ethical identity of the firm. Typically, organizations reveal their identity through the corporate statement. The corporate statement is an effective vehicle by which a firm's essential values and identity are communicated (Leuthesser and Kohli, 1997). In fact, many specialists in corporate identity recommend the corporate statement as the baseline for a corporate identity program.

The second component of the CEI refers to what we term *Corporate Applied Ethics* (CAE). This concept deals with all the actions and policies that can be considered as ethical and exceeds the simple communication of ethical values. It is important to distinguish between these ethical actions from other initiatives that are related to the good management of stakeholders

(Fisher, 2004). While the latter deals with every day activities like training programs or profit sharing schemes to employees, ethical actions refer to processes, activities, and events conducted on ethical basis and go beyond firm's daily functions. For instance, firms adopting procedures like ethic codes as a self-commitment device, taking initiatives like divesting from a country to avoid corruption problems, or participating in HIV/AIDS programs, can be considered as corporations applying ethics (Margolis and Walsh, 2003). Previous research has not made this distinction, using measures of both constructs into one aggregated measure. This may partially explain the ambiguous results in the past.

The division between these CRE and CAE will help us to obtain a better understanding of the relationships between Corporate Ethical Identity, Stakeholder Satisfaction, and Corporate Financial Performance. In the following sections, we relate these concepts.

Stakeholder Theory

Since stakeholders are engaged in the construction of the ethical identity of firms, a stakeholder approach appears as the appropriate framework. Moreover, management scholars studying ethical and social issues have mostly drawn on stakeholder theory (Freeman, 1984), generating an extensive body of research (Garriga and Melé, 2004; Margolis and Walsh, 2003).

Stakeholder theory deepens its roots in the notion of corporate social responsibility (Carroll, 1979; Clarkson, 1995; Wartick and Cochran, 1985; Wood, 1991) and in the seminal book of Freeman, (1984), *Strategic Management: A Stakeholder Approach*. The main thesis of the theory is that the firm is responsible for managing and coordinating the constellation of competitive and cooperative interests of different constituencies or stakeholders. Thus, firms have multiple goals other than the solely shareholder's value maximization end, as the traditional economic theory proposes (Friedman, 1970).

As stakeholder theory developed and grew in number of supporters, however, it also varied in different interpretations and arguments for its justification (Donalson and Preston, 1995). In applying stakeholder theory we can distinguish two almost entirely separate methodological strands of literatures: on one hand, the *normative stakeholder literature*, which is theoretically based and emphasizes the ethical and moral standards as the only acceptable way for corporate behavior, independently of the repercussions of these behaviors on the firm's performance. On the other hand, the *instrumental stakeholder literature* focuses primarily on stakeholder orientation as a mean of achieving corporate success. This latter line of research is more empirically based (Berman et al., 1999; Donalson and Preston, 1995; Jones and Wicks, 1999).

The normative versus the instrumental split in the stakeholder theory has put as a separated issue from the world of business and this has riddled proper analysis. Indeed, the conflicting point of whether stakeholder orientation and satisfaction should be the final goal (i.e. normative) or a mean to achieve better performance (i.e. instrumental) increases the confusion about the role of business ethics on the performance of firms.

Recently, however, some scholars have made an attempt to integrate the two separated strands (Gibson, 2000; Jones, 1995; Jones and Wicks, 1999). The underlying rationale of all these studies is that ethical behaviors—a normative orientation—can result in a significant competitive advantage—instrumental orientation. Ethical principles and behaviors allow trusting and cooperative relationships among stakeholders, which lead to a reduction in opportunism as well as in contracting costs. At the end, there is an improvement in a firm's competitive advantage over those firms that don't rely on ethical principles. While some academicians have shown their skepticism about this integrative view (Donalson, 1999; Freeman, 1999; Schwab, 1996; Treviño and Weaver, 1999), we believe it provides a key avenue for research in ethical and social issues.

Following this integrative line of research, we propose that both normative and instrumental strands contain a kernel of truth, but none provides sufficient grounds for a model that relates business ethics and firm financial performance. While the normative approach emphasizes the intrinsic worth of stakeholders in isolation of financial performance, the instrumental approach ignores business ethics as valuable concept on itself. Together, however, they provide an adequate framework to explain this relationship. From the normative strand, we derive the relevance of business ethics as the driving force for stakeholder satisfaction. From the instrumental strand, we assess the link between stakeholder satisfaction and better financial performance. Figure 1 illustrates our theoretical model and presents the central arguments, concepts, and relationships of this study.

[Insert Figure 1 about here]

Stakeholder Satisfaction through Corporate Ethical Identity: A Normative Approach

The normative strand is characterized by the incorporation of ethical and moral principles in the firm's decisions making, in particular with respect to how it manages its stakeholders (Donalson and Dunfee, 1994; Evan and Freeman, 1983; Philips, 1997; Wicks et al., 1994). The normative approach underlies two main characteristics. First, stakeholders have legitimate interests on the corporate activities independently of whether the corporation has instrumental interests in them. Second, each stakeholder is of intrinsic worth (Donalson and Preston, 1995).

Thus, the normative core of stakeholder approach prescribes that a firm should incorporate ethical standards in order to achieve stakeholder satisfaction, which should be the final goal of the firm because the intrinsic worth of their interests. These interests are based on ethical and moral principles and are not necessarily related to their instrumental worth to the corporation (Berman et al., 1999; Donalson and Preston, 1995; Evan and Freeman, 1983).

According to this logic, we expect a positive relationship between the CEI of the firm and the stakeholder satisfaction to the extent that the firm successfully serves the ethical claims of its stakeholders. As previously argued, the ethical identity of a firm is constructed based on the expectation of stakeholders to whom the firm interacts. Consequently, different groups like managers and employees (Das, 2005; Grojean et al., 2004), government (Rockness and Rockness, 2005), consumers (Rawwas et al., 2005), and other constituencies (Phillips and Reichart, 2000) play a key role in the definition of the ethical stance of the firm. And the manner a firm responds to the stakeholders' ethical claims defines its CEI (Fombrun and Foss, 2004; Fritz et al., 1999; Logsdon and Yuthas, 1997). Because stakeholders expect business to fulfill its ethical responsibilities and its philanthropic duties (Ferrell et al., 2000), ethical manifestations stimulate the trust and commitment between the stakeholders and the firm, which derive in a stronger relationship and a higher satisfaction (Fritz et al., 1999; Hosmer, 1994; Strong et al., 2001). When a firm explicitly adopts an ethical identity coherent with the stakeholders' ethical expectations, these groups feel that their voices are being heard and consequently exhibit larger satisfaction. By contrast, a firm with a poor CEI is likely to show an increase stakeholders dissatisfaction because their ethical demands are not attended. Thus, a firm that successfully follows the stakeholder normative prescription by capturing the ethical claims of their stakeholders, communicating its ethical standards, and embarking in ethical initiatives (i.e. a strong CEI) should achieve greater degree of stakeholder satisfaction. This rationale is capture in our first hypothesis.

Hypothesis 1a: *Corporate Ethical Identity of the firm has a positive influence on stakeholder satisfaction.*

However, we expect differentiating effect of the two components of CEI on stakeholder satisfaction. Clearly, ethical disclosure enhances stakeholder satisfaction in that it communicates the firm's ethical posture and brings together its identity with the expectation of stakeholders. Still, we suggest that CAE should have a greater impact than CRE. While CRE signals the ethical stance of the firm and acts as declaration of purpose for the firm's future actions, CAE are concrete, specific-oriented activities to the needs of stakeholders who demand an ethical behavior from the firm. Stakeholders evaluate how well companies perform according to their ethical standards and exhibit a certain degree of fulfillment only when they experience in a tangible manner the results of corporate behavior (Logsdon and Yuthas, 1997). This suggests that the plain manifestation of the ethical values decoupled from ethical actions may be not valuable for stakeholders. Therefore, we expect that firm's tangible ethical initiatives in line with the demands of their stakeholder are more effective in boosting the level of satisfaction than the simple revelation of the ethical beliefs of the firm. The previous arguments are captured in next hypothesis.

Hypothesis 1b: *Corporate Applied Ethics has a stronger influence on stakeholder satisfaction than Corporate Revealed Ethics.*

Financial Performance through Stakeholder Satisfaction: An Instrumental Approach

The other main strand of the stakeholder theory is the instrumental approach. It indicates that a stakeholder orientation of the firm is a source of competitive advantages, which in turn will derive in better financial performance. A key assumption of this approach is that the firm's ultimate goal is the marketplace success, and the satisfaction to stakeholders' claims help to achieve this goal (Donalson and Preston, 1995; Freeman, 1984). This ultimate objective may not be related to the wellbeing of the stakeholders in general, but to the interest of the shareholders in particular. Thus, stakeholder management has a strategic value, as opposed to the intrinsic value of the normative approach, and it is therefore a "means to an end" perspective (Berman et al., 1999).

The instrumental approach suggests the formulation and implementation of process that satisfies stakeholders as they have a stake in the firm and control key resources (Pfeffer and Salancik, 1978), which in turn, will ensure the long-term survival and success of the firm (Freeman, 1984; Freeman and McVea, 2001; Hillman and Keim, 2001; Post et al., 2002). Accordingly, stakeholders own relevant resources to the firm's success and these groups and individuals will be more willing to facilitate their resources to the extent that their different claims and needs are fulfilled (Strong et al., 2001). Therefore, we expect that stakeholder satisfaction leads to a higher commitment, greater effort, and ultimately superior performance (Hosmer, 1994; Stevens et al., 2005). This is captured in hypothesis 2.

Hypothesis 2: S*takeholders satisfaction has a positive influence on the firm's financial performance.*

Financial Performance through Corporate Ethical Identity: The mediating role of Stakeholder Satisfaction

Whether or not business ethics has a positive influence on financial performance it is still an open research question. Some authors (Friedman, 1970; Jensen, 2001; Schwab, 1996) assert that the only social function of the firm is to maximize the shareholder value while complying with the rules of the market. This line of research argues ethical investments are in conflict with the primary profit-oriented strategies of the company. Authors argued that if investor cared enough about ethical behavior under the enactment to punish bad performance, firm would have a market-based incentive to behave ethically. The existence of regulations like the Sarbanes-Oxley legislation (Rockness and Rockness, 2005) is an indication that such incentives are uncertain.

By contrast, other authors have argued that proactive ethical initiatives have a positive impact on financial performance because ethical behaviors derive in the creation of intangible assets, which are vital to the long-term business success (Jones, 1995; Jones and Wicks, 1999). Intangibles like good reputation, trust, and commitment are generated trough a strong ethical stance (Fombrun et al., 2000; Hosmer, 1994). We agree with this latter line of research. By behaving ethically, a company generates intangible gains that improve its ability to attract resources, enhance performance, and build competitive advantages while satisfying its stakeholders' needs (Fombrun et al., 2000). As presented earlier in this paper, we propose that CEI has a positive effect on the stakeholder satisfaction (hypothesis 1a) because stakeholders expect the firm to fulfill their ethical demands. To the extent that ethical claims are attended, the satisfaction level increases, and stakeholders are more willing to affably interact with the firm, providing their resources and effort, which in turns derives in enhanced performance results (hypothesis 2). Therefore, we suggest that the relationship between business ethics and financial performance is not straightforward but instead it is mediated by the level of stakeholder satisfaction. That is, we expect an indirect effect between the CEI of the firm and its financial performance.

Hypothesis 3a: S*takeholders Satisfaction mediates the relationship between Corporate Ethical Identity and the firm's financial performance.*

However, when we decompose CEI into its two dimensions, we expect distinguishable effects on financial performance.

Traditional capital market studies have largely acknowledged the role of disclosing information in the performance of firms. Information and incentive problems obstruct the efficient allocation of resources in a capital market economy, and disclosure plays a key role in mitigating these problems (Healy and Palepu, 2001). Prior research has also extensively examined the levels of disclosure of social activities and its effect, in particular when analyzing the relationship between Corporate Social Performance and Corporate Financial Performance (see Margolis and Walsh, 2003; Orlitzky et al., 2003; Walsh et al., 2003 for recent reviews). Environmental accounting scholars have additionally shed some light by analyzing the impact of voluntary environmental disclosure on firm performance (Cragg, 2002; Lorraine et al., 2004). As a whole, these two lines of research offer supporting evidence in favor of the positive relationship between social disclosure and financial performance.

Similarly, we expect CRE has a positive impact on the financial performance of the firm. CRE can have beneficial value to for several reasons. First, it enhances the appeal of the firm's shares to the ethical and socially responsible investors (Cragg, 2002; Lorraine et al., 2004).

When a firm discloses its ethical values and objectives on its corporate statements it equates them in importance to other organizational goals. Second, it provides a clear signal about the stance and beliefs of the firm, reducing uncertainty about future actions and long-term risks (Sethi, 2005). Third, ethical disclosure attends the investors' need for ethical and social information (Hummels and Timme, 2004), which in turn helps to achieve better long-term investment decisions (Sethi, 2005). Forth, it may be a valuable tool to create intangible assets like good corporate image and enhanced reputation, which can be sources of competitive advantage (Fombrun, 1996; Fombrun and Foss, 2004; Hillman and Keim, 2001). Fifth, a clear statement of what the firm stands for can stimulate trust and commitment between shareholders and top managements, reducing opportunistic behaviors and transactional costs (Hosmer, 1994; Jones, 1995). Last, investor may interpret an ethical statement as a positive signal regarding the resources of the firm. Only companies with sufficient resources can embark in ethical enterprises (cf. Orlitzky et al., 2003; Waddock and Graves, 1997). In short, CRE has an important informational value and we expect that investors incorporate ethical information on their assessment of the firm value.

Whereas CRE is expected to increase shareholder value because the aforementioned arguments, CAE are initiatives that are oriented to specific stakeholders' needs and they do not necessarily represent investments subject to return evaluation (Fombrun et al., 2000). Following the example presented earlier in this article, divesting from a country to avoid corruption problems can be considered an ethical initiative but it does not necessarily represent an optimal decision from a maximizing value perspective. Similarly, investing in HIV/AIDS programs can be of fundamental importance for the ill community but is not expected to have a direct impact on the financial performance of the firm. Hillman and Keim (2001) presented empirical evidence suggesting that participating in social initiatives unrelated to primary stakeholders hindered shareholder value. While these initiatives may have some potential reputation benefit and a positive impact on the stakeholder satisfaction (hypothesis 1b), they are costly in term of organizational resources with dubious future pay-offs (Fombrun et al., 2000; Hillman and Keim, 2001). Moreover, investors may rely on the observed stakeholder satisfaction as an indicator of the appropriateness of ethical initiatives, rather than on the initiatives themselves.

Therefore, we expect, on the one hand, that the informational value of CRE impact the financial performance of the firm, even after controlling for its effects on stakeholder satisfaction. On the other hand, we expect no further positive impact of CAE beyond the positive effect on stakeholder satisfaction. This implies that the effect of CAE on performance is fully mediated by the stakeholder satisfaction. These two ideas are captured in our last hypothesis.

Hypothesis 3b: *Corporate Revealed Ethics has a positive influence on the financial performance, even after controlling for stakeholder satisfaction, whereas Corporate Applied Ethics has no further influence.*

METHODS

Sample and Data

We build up our data sample from 2002 SiRi Global Profile database, compiled by Sustainable Investment Research International (SiRi) Company. This company is the world's largest company specialized in the analysis of socially responsible investment. SiRi Company comprises eleven independent research institutions, such as Kinder, Lyndenburg, Domini (KLD) Research & Analytics Inc in USA, or Pensions & Investment Research Consultants Ldt. in U.K.

SiRi Company reports rely on each company's reporting procedures, policies and guidelines, management systems, and key data. This information is extracted from financial accounts, company documentation, international databases, media reports, interviews with key stakeholders, and, primarily ongoing contact with management representatives. Each firm's profile contains over 350 data points that cover all major stakeholder issues such as community involvement, environmental impact, customer policies, employment relations, human rights issues, activities in controversial areas (e.g. alcohol), supplier relations, and corporate governance. We complement the information on social and ethical issues with information on financial data extracted from the OSIRIS database for the years 2000-2003. This is a comprehensive database of listed and large unlisted companies all over the world compiled by Bureau Van Dijk. It contains balance sheets, income statements, cash flow statement, and stock data. It is important to note that OSIRIS's information is standardized given the differences in accounting practices among the different countries of the database.

We excluded financial firms as well as those that do not provide complete information on financial data from our sample. The final sample is composed of 515 companies that belong to 26 different countries[1]. Our data only allows a cross-sectional analysis because we only have one-year information of SiRi Global Profiles. This is not very critical in our analysis given the large inertia of a firm's ethic policy (Agle et al., 1999).

Measures

Corporate Ethic Identity **(CEI)**. We operationalized this variable through the sum of its two basic ethic components:

Corporate Revealed Ethic (CRE). To measure this variable, we used the SiRi Global Profile database, which contains a business ethics report. In the first part of this report, SiRi analysts study the corporate statement, assessing whether the company discloses relevant information on its business ethics organization or behavior. As a result, SiRi builds a dummy variable, where the company is scored with one on this item when discloses information on business ethics in the corporate statement; otherwise, the company receives zero. In our empirical application, we used this item provided by SiRi.

Corporate Applied Ethics (CAE). We measure this construct using another dummy variable. In this case, the SiRi analysts assess the business ethics initiatives, policies, and procedures. Concretely, the company is inspected in order to identify if it has precise procedures (and the scope of these procedures) whose goal is to avoid any action non compliant with business ethics. These procedures provide an overview of the ethical practical behavior of the firm toward its stakeholders. The company is labeled as "ethical" if it conducts the following initiatives: a withdraw from a market to avoid corruption problem, an explicit employee ethical policy, if this policy is easily available, there is a contact person in case of irregularities, the reporting agent remains anonymous, and sanctions are provided for unethical behaviors. When the company does not have business ethics procedures it receives zero punctuation.

Stakeholder Satisfaction **(SS).** This variable is viewed as a multidimensional construct (Carroll, 1979). Ideally, it should capture a wide range of items and at least one for each relevant stakeholder (Waddock and Graves, 1997). We use SiRi Global Profile data sections, which are devoted to measure the level of a firm's responsibilities to its stakeholders, namely, community, corporate governance, customers, employees, environment, and vendors and contractors. In our study, we use the final score provided by SiRi, which quantifies the degree to which the company satisfies the stakeholders' interests, ranging the stakeholder satisfaction from 0 (worst) to 10 (best). Taking into account the punctuation received by each stakeholder, SiRi build an aggregate score, which is our final measure of *stakeholder satisfaction*.

Corporate financial performance **(CFP).** We approximate the financial performance of firms with the Market Value Added (MVA). This is calculated as the equity market valuation of the company minus the capital invested in the company. It could be interpreted as the stock market's estimation of net present value (Hillman and Keim, 2001). We use a market measure instead of an accounting measure like ROA (return on assets) or ROE (return on equity), because the effects of a firm's ethic policies are only visible in the long-term. As markets measures are forward looking, we expect that they incorporate in the short-term the expected long-term effects linked to ethic policies (additional justification for market measures are discussed in Orlitzky et al., 2003).

Control variables. We controlled for firm size, industry, risk, and country. In doing so, we followed the lead of Waddock and Graves (1997), and due to the international content of our database, we also controlled by country. We operationalized these variables as follows:

Size is defined in terms of a firm's total sales on a log scale. The size of a firm is a standard factor in explaining the ethic basis of CFP and SS. A firm's commitment to a particular ethic behavior as well as the available instrument to implement this commitment is expected to be sensible to the size of a firm. Larger firms tend to be more visible and receive more stakeholder scrutiny, which influences their identity (Fombrun, 1996).

Risk, which is approximated by a firm's beta (Hillman and Keim, 2001) as reported by OSIRIS. This variable is recognized as a pivotal determinant in any estimation of financial performance. Moreover, we allow this variable to affect stakeholders' satisfaction. Stakeholder wellbeing is expected to be related to the possibility of financial distress (Roberts, 1992). A firm with a strong orientation towards its stakeholder may be viewed as better managed and therefore less risky and, *viceversa*, a firm with lower risk is more likely to commit to its stakeholders.

We control for industry and country. *Industry* effects are captured by a 4-digit SIC dummy variables (DummyS). There are 13 sectors in our sample. Finally, to control for *country* influences, we use (DummyC), one for each of the 26 countries that our sample is composed of.

Finally, in order to prevent potential endogeneity problems between measures, we used the mean of all our variables. The use of mean variable is consistent with previous studies like McWilliams and Siegel (2000). The underlying idea is that by averaging variables, it is possible to find more robust coefficients in the estimations as the error terms are less correlated with the average independent variables.

Data Analysis and Model specification

To test our hypotheses, use Ordinary Least Squares (OLS) regression analysis with White's correction, which solves some heteroskedasticity problems. We rely on two basic specifications. The first one explains SS. The second one explains CFP. The main independent variable in both cases is the CEI, which is also decomposed into CRE and CAE. Following previous research (Waddock and Graves, 1997), we consider the same set of control variables in explaining CFP as well as SS. In order to explain a firm's SS and test Hypothesis 1a, we consider the following specification:

$$SS_i = \alpha_0 + \alpha_1 CEI_i + \alpha_2 SIZE_i + \alpha_3 RISK_i + \sum_{K=1}^{12} \alpha_{3+K} DummyS + \sum_{K=1}^{25} \alpha_{15+K} DummyC \qquad (1)$$

In order to analyze the possible differential effect of CRE and CAE on SS stated in Hypothesis 1b, we conducted two different estimations of specification (1) by decomposing variable CEI into its two basic components: CRE and CAE.

The second specification is aimed at explaining CFP. As aforementioned, we contemplate the same basic control variables as specification (1) but we allow for some changes in order to test the remaining hypotheses. First, to test Hypothesis 2, we introduce SS variable and we exclude CEI variable in order to study the existence of a direct effect of SS on CFP. Second, in order to study the existence of a direct effect of a firm's ethic behavior on its CFP, we introduce CEI variable or its basic components, but we do not incorporate SS variable. Third, to test Hypothesis 3a we introduce SS and CEI variables in the specification. This allows studying whether a mediating effect of SS exists in the linkage between a firm's ethic identity and its financial performance. Finally, by separating in the previous specification CEI variable in its two basic components, CRE and CAE, we can test whether there is a differential mediating effect of SS on the connection between a firm's ethic dimension and its performance dimension. Hence, the basic specification we are working with is as follows:

$$CFP_i = \beta_0 + \beta_1 SS_i + \beta_2 CEI_i + \beta_3 Size_i + \beta_4 Risk_i + \sum_{K=1}^{12} \beta_{4+K} DummyS + \sum_{K=1}^{25} \beta_{16+K} DummyC \quad (2)$$

Finally, in terms of the significance of the coefficients, Hypothesis 1a holds whenever α_1 is positive, while Hypothesis 1b works if the coefficient of CRE is larger than that of CAE in specification (1) that decompose CEI variable into its two basic components. Hypothesis 2 is confirmed when β_1 is positive in specification (2) that does not include CEI variable. Finally, Hypothesis 3a holds when β_1 is positive in specification (2) including CEI variable. And, in this latter specification when we decompose CEI variable into its two basic components, we expect the coefficients of CRE to be positive while that of CAE non-significant in order to find support for Hypothesis 3b.

RESULTS

Table 1 reports means, standard deviations, and correlations between main variables used in the study.

[Insert Table 1 about here]

Analysis of the correlation matrix shows that CEI and SS are positively correlated. This offers preliminary support to Hypothesis 1a. Comparing the correlation coefficient between CAE and SS with the one between CRE and SS, we find that the former is larger and more significant than the latter. This provides initial support to the differential effect stated in Hypothesis 1b. Also, SS and CFP are positively correlated, as predicted in Hypothesis 2. Finally, CEI as well as its two basic components are positively related with CFP.

Table 2 summarizes the regression analysis of specification (1), where we test the effect of a firm's CEI on SS (Model 1A). Also, we decompose CEI into the two basic components: CRE and CPE (Models 2A, 3A and 4A).

[Insert Table 2 about here]

Model 1A shows that the α_1 coefficient for CEI is positive and highly significant ($p \leq 0.01$) for explaining SS. These results provide strong support for Hypothesis 1a. Also, when we decompose CEI into its two basic components (Models 2A, 3A and 4A), we find that both are positive and highly significant ($p \leq 0.01$), and that CAE ($\alpha = 0.350$, $p \leq 0.01$) contributes more than CRE ($\alpha = 0.268$, $p \leq 0.01$) to the SS. Thus, there is strong support for Hypothesis 1b.

Finally, table 2 exhibits that the control variable measuring size is significant, but risk is not. This latter result is consistent with the evidence provided by Waddock and Graves (1997).

Table 3 displays the regression analysis results for specification (2), which pertains SS, CEI, and CFP.

[Insert Table 3 about here]

Model 1B tests the direct effect of SS on CFP. Results indicate that the effect of stakeholder satisfaction on financial performance is positive and highly significant ($p \leq 0.01$). This provides strong support for Hypothesis 2.

In order to test the mediating role of stakeholder satisfaction in the relationship between CAI and CFP, we first analyzed the direct effects of CEI and its two components on CFP (Models 2B and 3B, respectively). Results indicate all these variables have a direct positive effect on CFP. Later, we introduced SS as explanatory variable of CFP (Models 4B and 5B). Comparing the CAI coefficients in models 2B and 4B, we observe that the latter is smaller and less significant (β = 0.048, $p \leq 0.05$) than the first one (β = 0.059, $p \leq 0.01$) in line with Hypothesis 3a. Still, the CEI coefficient remains significant after controlling for SS (also significant $p \leq 0.05$), indicating that SS partially mediates the relationship between CEI and CFP. Thus, this result partially confirms Hypothesis 3a.

Model 5B tests the differential effects of ethical identity components on CFP when controlling for SS. We find that CAE has no direct effect on CFP ($p > 0.1$), while CRE has a positive and significant influence ($p \leq 0.05$) after controlling for SS. Therefore, the relationship between CAE and CFP is fully mediated by SS whereas CRE is only partially mediated by SS. These results support Hypothesis 3b.

Nevertheless, the positive impact of CRE on CFP should be taken with caution due to the complementarity nature of both ethic dimensions. To test this notion of complementarity, we forced the dummy for CAE to be equal to zero. It is interesting to notice that all firms from our sample using ethical programs (CAE) revealed their ethical posture in their corporate statement (CRE). Moreover, some firms disclose their ethical posture but do not conduct ethical programs. Model 6B shows that the effect of CRE on financial performance would be negligible when firms do not put in place ethic initiatives (i.e. CAE=0). Thus, revealing ethical information does not improve *per se* financial performance. Applied ethic actions are needed in order to take full advantage of ethic disclosure. Lastly, in accordance to Hillman & Keim (2001), we find that size has a significant effect on CFP while the effect of risk can be neglected.

DISCUSSION AND CONCLUSION

In this paper we have investigated the connection between corporate ethic identity (CEI) and Corporate Financial Performance (CFP) and the role of Stakeholder Satisfaction (SS) in mediating this relationship. As expected, this study showed that a strong CEI was positively related to high levels of SS. In turn, stakeholder satisfaction had a positive influence on the financial performance of the firm. As a result, we conclude that the relationship between CEI and CFP is mediated by SS. Moreover, we found that each dimension of CEI, that is Corporate Revealed Ethics (CRE) and Corporate Applied Ethics (CAE), has distinctive effects on both SS and CFP. On one hand, CAE has a bigger influence than CRE on SS. This suggests that stakeholders obtain more value from tangible ethical actions than from simple ethical revelation. On the other hand, we found that CRE has a positive informational effect on shareholders' value after controlling for SS, while CAE has no further impact on stock market value. However, we also found that ethical disclosure by itself is not sufficient to enhance financial performance. This suggests a complementary role between the two dimensions of CEI.

These results are important for both management researchers and practitioners, as conclusions derived are not only theoretically meaningful but they have a clear practical content.

Implications for research

The contribution of our study to existing literature is threefold. First, we drawn on both normative and instrumental stakeholder theory to developed our theoretical framework. Overall, we found support for our theoretical contentions. Our study is one of the first in providing empirical evidence supporting the integrative strand of the stakeholder theory (Gibson, 2000; Jones, 1995; Jones and Wicks, 1999). This integrative approach appears as a promising theoretical framework to bring together ethics and business. We suggest the stakeholder satisfaction as the union between these two apparently separated worlds. Future research can refine this concept and search for additional connecting elements.

Second, our results indicate that a strong ethical identity can have both intrinsic and strategic value. To this regard, there have been controversies about the application of ethics as a strategic tool. For instance, Queen and Jones (1999) argued that ethical initiatives justified on strategic basis are, in fact, unethical and unlikely to provide economic benefits because an ethical stance is hard to fake when its underlying motivation is the profit maximization. Hillman and Keim (2001) also argued that participating in social and ethical issues may adversely affect the firm's ability to create shareholder wealth. However, our results show that a well-built CEI has direct and indirect positive influences on financial performance.

Finally, our work also provides initial understanding of the ethical dimensions of corporate identity, a neglected aspect until recently. Moreover, we suggest operational measures of this construct and its dimensions. Corporate identity researchers can extend this study by analyzing at a deeper level the type of relationship between CRE and CAE. While this study provides evidence for the complementary relationship between these two constructs, further research is needed to fully appreciate their importance in dynamic contexts. In particular, future scholarly work should analyze the creation process of ethical identity and how it evolves over time.

Implications for practice

Consistent with the findings of previous studies (Berman et al., 1999; Hillman and Keim, 2001), we found that firms satisfying the stakeholders' demands have higher economic benefits and differentiate from competitors. Developing close relationships with key stakeholders creates intangible resources that are the basis for a sustainable competitive advantage. Hence, managers should recognize the importance of these relationships and place them on their strategic agenda.

From a maximizing shareholder value perspective, previous research has depicted the importance of social disclosure on the firm's value. At the same time, some studies have shown that investing in ethical and social initiatives can be in some cases against the shareholders' best interest (Hillman and Keim, 2001). Our study validates the relevance of ethical disclosure practices as investor may be able to internalize the expected future benefits through their investment decisions in financial markets. Therefore, revealing ethical values and beliefs in accordance to those of the stakeholders appear to be an adequate strategy for managers to follow.

However, our study also shows that while ethical initiatives do not necessarily represent profitable investments (i.e. there is not a direct influence), they are indeed a key determinant of stakeholder satisfaction. In turn, stakeholder satisfaction boosts financial performance. Thus, ethical actions have an indirect effect on financial performance through stakeholder satisfaction.

Moreover, we showed that if firms decide to adopt an ethical disclosure policy disconnected from their actions, they may hinder their value, as we found evidence of the complementarity between CRE and CAE. A company that only adopts ethics in a symbolic manner (Stevens et al., 2005) —that is decoupled from actions—jeopardizes its own future. Managers should be aware of the fact that relying exclusively on ethical disclosure is not enough. Firms will fully obtain the positive influence of ethics only when the ethical revelation is substantively coupled to ethical activities. Consequently, effective management of ethical identity implies a balance between ethical communications and ethical behaviors.

Final remark

Ethics and business are not unrelated worlds. Our work provides evidence that acting well is ultimately in the company's best financial interest. It also shows that ethics is good in terms of social performance as it provides greater degree of satisfaction to stakeholders. Thus, effective management of corporate ethical identity can play a significant role for the overall firm performance.

FOOTNOTES

(1) The distribution of firms by country is as follows: There are 30.49% of US firms; 17.28% of UK firms; 12.23% of Swiss firms; 6.6% of French firms; 6.02% of Japanese firms; 5.63% of German firms; 4.08% of Dutch firms; 3.3% of Italian firms; 2.72% of Sweden firms; 1.94% of Spanish firms; 1.36% of Belgian firms; 1.36% of Finnish firms; 1.17% of firms from Hong Kong; 0.97% of Canadian firms; 0.97% of Danish firms; 0.78% of Irish firms; 0.58% of Australian firms; 0.58% of Korean firms; 0.39% of Norwegian firms; 0.39% of Portuguese firms; and finally, there is one firm from each of the following countries: Austria, China, Luxemburg, Taiwan, Thailand and Singapore.

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TABLE 1

Descriptive Statistics and Spearman Correlations [a]

	Mean	s.d.	Min.	Max.	1	2	3	4
1. Financial Performance	1.2e+09	8.5e+09	-2.7e+07	1.9e+11				
2. Stakeholder Satisfaction	4.640	1.532	0.208	8.734	0.048*			
3. Corporate Ethic Identity	1.062	0.670	0.000	2.000	0.080***	0.393***		
4. Corporate Revealed Ethic	0.805	0.396	0.000	1.000	0.047*	0.284**	0.840***	
5. Corporate Applied Ethic	0.257	0.437	0.000	1.000	0.091***	0.391***	0.888***	0.518***

[a] $n = 515$

* $p \leq 0.10$
** $p \leq 0.05$
*** $p \leq 0.01$

TABLE 2

Results of Regression Analyses for Stakeholder Satisfaction [a]

Variable	MODEL 1A	MODEL 2A	MODEL 3A	MODEL 4A
Corporate Ethic Identity	0.440***			
Corporate Revealed Ethic		0.268***		0.268***
Corporate Applied Ethic			0.350***	0.350*** , [b]
Controls				
Size	0.114***	0.158***	0.112***	0.116***
Risk	–0.002	0.001	–0.021	–0.001
Sector' Dummies	Yes	Yes	Yes	Yes
Country's Dummies	Yes	Yes	Yes	Yes
Constant	1.335***	0.973***	1.498***	1.309***
R^2	0.3647	0.2505	0.2982	0.3652
F Test	65.95***	41.81***	82.08***	62.21***
N	515	515	515	515

[a] Standardized regression coefficients are shown in the table.

[b] The test of equality of coefficients showed that the marginal effect of applied ethics is significantly higher than that of revealed ethics ($F = 6.13$; $prob > F = 0.013$).

* $p \leq 0.10$

** $p \leq 0.05$

*** $p \leq 0.01$

TABLE 3

Results of Regression Analyses for Financial Performance [a]

Variable	MODEL 1B	MODEL 2B	MODEL 3B	MODEL 4B	MODEL 5B	MODEL 6B
Stakeholder Satisfaction	0.048***			0.025**	0.025**	0. 038*
Corporate Ethic Identity		0.059***		0. 048**		
Corporate Revealed Ethic			0.033***		0.027**	0.020
Corporate Applied Ethic			0.048*		0.040	
Controls						
Size	0.195***	0.197***	0.197***	0.194***	0.194***	0.163***
Risk	–0.012	–0.011	–0.011	–0.011	–0.011	–0.015
Sector' Dummies	Yes	Yes	Yes	Yes	Yes	Yes
Country's Dummies	Yes	Yes	Yes	Yes	Yes	Yes
Constant	–0. 289***	–0.318***	–0.318***	–0.328***	–0.329***	–0.264**
R^2	0. 3943	0.3959	0.3959	0.3964	0.3964	0.5093
F Test	4.41***	4.10***	3.97***	4.39***	4.33***	9.50***
N	515	515	515	515	515	132

[a] Standardized regression coefficients are shown in the table.

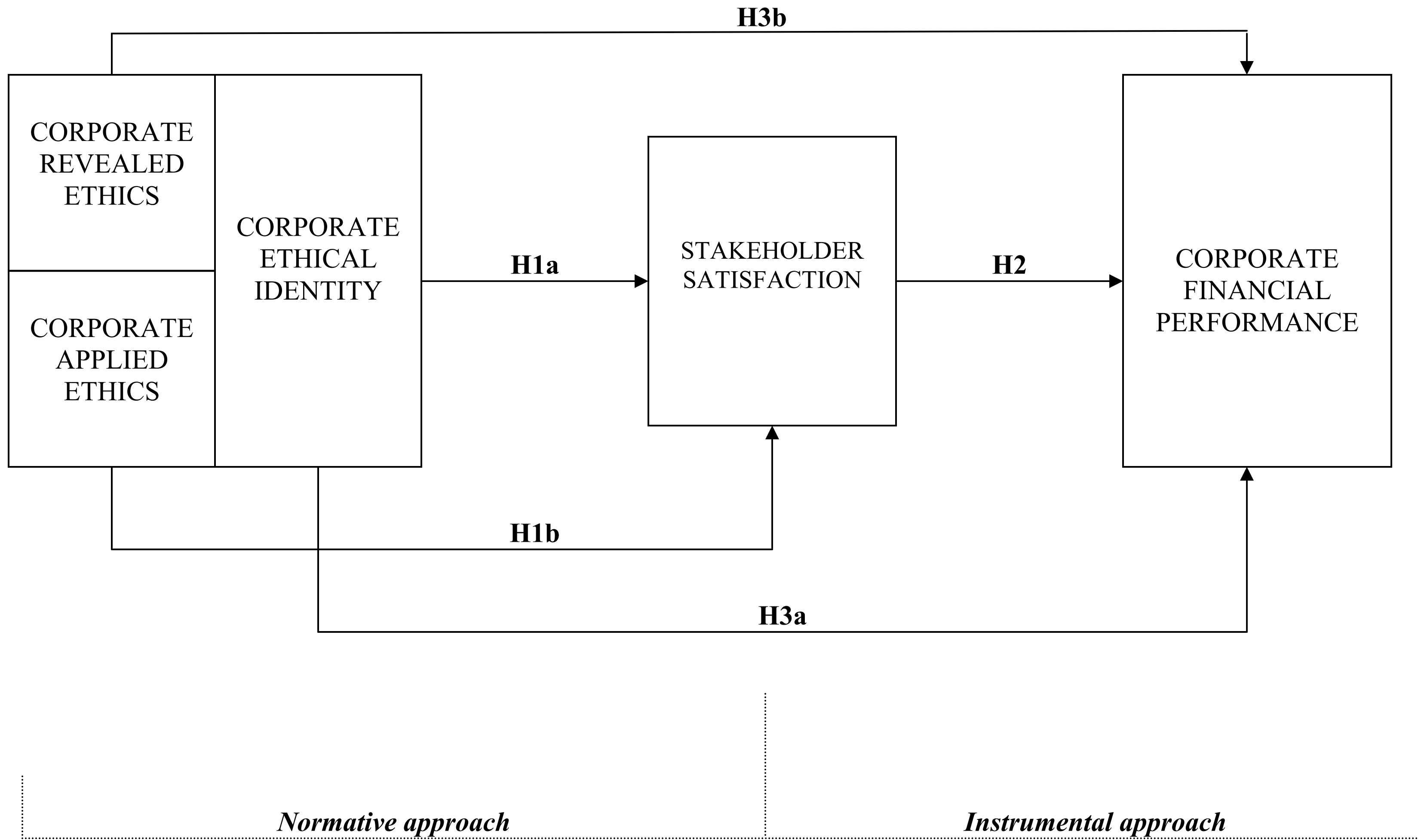
$^{*}p \leq 0.10$

$^{**}p \leq 0.05$

$^{***}p \leq 0.01$

FIGURE CAPTIONS

Figure 1: Corporate Ethical Identity and its Effects on Stakeholder Satisfaction and Financial Performance


H3b
CORPORATE REVEALED ETHICS
CORPORATE APPLIED ETHICS
CORPORATE ETHICAL IDENTITY
H1a
STAKEHOLDER SATISFACTION
H2
CORPORATE FINANCIAL PERFORMANCE
H1b
H3a
Normative approach
Instrumental approach