

# Corporate Ethical Identity as a Determinant of Firm Performance: A Test of the Mediating Role of Stakeholder Satisfaction

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

**KEY WORDS:** business ethics, corporate ethical identity, financial performance, stakeholder satisfaction, stakeholder theory

**ABBREVIATIONS:** CEI: corporate ethical identity; CRE: corporate revealed ethics; CAE: corporate applied ethics; SiRi: sustainable investment research international; KLD: Kinder, Lydenburg, Domini Research and Analytics Inc.; SS: stakeholder satisfaction; CFP: corporate financial performance; MVA: market value added; ROA: return on assets; R&D: research and development

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## Introduction

During the last decades, the ethical behaviour of firms and the potential effects of malfeasance on society have attracted the interest of researchers and the business press alike. Recently, business ethics has generated 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 the media, and increased pressure from various 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). In the academic arena, the proliferation of specialized journals like *Journal of Business Ethics* and *Business Ethics Quarterly* are testaments to growing interest in the subject.

There is still a number of unresolved academic issues in the area of business ethics and social responsibility of the firm, however (Donaldson, 2003; Harrison and Freeman, 1999; Walsh et al., 2003). Specifically, knowledge about existing linkages

between a firm's ethical stance and its performance remains limited at best. There are theoretical and empirical reasons for this situation. From a theoretical point of view, there is controversy over the effect of business ethics and good corporate behaviour on a firm's financial performance. Some authors (Hosmer, 1994; Jones, 1995) argue that good ethics is good business because it generates positive externalities like trust and commitment to stakeholders, which in turn assures long-term performance. Others remain skeptical (Friedman, 1970; Jensen, 2001; Schwab, 1996). The skeptics argue that ethical initiatives are investments without pay-offs and therefore against the shareholder's best interest. Unfortunately there is limited empirical work that has explicitly addressed these corporate ethical issues and the existing research has shown mixed results (e.g. Berman et al., 1999; Hillman and Keim, 2001). Thus the question remains: Is ethical behaviour a good predictor of business performance (Gibson, 2000)?

An interesting avenue for exploring the relationship between ethics and performance is through the perspective of corporate identity – the set of interdependent characteristics of the organization that give it distinctiveness: organizational philosophy, values, history, strategy, business scope, and communication, for instance (Balmer, 1998, 2001; van Riel and Balmer, 1997). Since corporate identity is recognized as a source of competitive advantage (Balmer and Gray, 2000), we suggest that a firm's ethical stance (i.e., its ethical values, behaviours, and communications on ethical commitments) can be seen as a component of the firm's corporate identity that may enhance corporate performance.

Despite the significance that corporate identity research has recently engendered (Balmer, 1998, 2001), previous research has largely ignored the ethical dimension of corporate identity and its relationship to a firm's performance. This study aims to fill this gap in several ways. First, we define the ethical component of the corporate identity construct with a concept that we call *corporate ethical identity* (CEI). Relying on the notion of corporate identity, we define CEI as “the set of behaviours, communications, and stances that are representative of an organization's ethical attitudes and beliefs”. This narrowly defined concept encompasses two aspects: *corporate revealed ethics* (CRE), which comprises the communication of a firm's ethical attitudes

and beliefs, and *corporate applied ethics* (CAE), which comprises the firm's behaviours – actions and policies that can be considered as ethical.

A second way in which we aim to contribute to this literature is by drawing on stakeholder theory to propose a theoretical scheme whereby the gap between performance and ethics – specifically CEI – is bridged by stakeholder satisfaction (SS). Stakeholders play a key role in the formation of society's ethical demands and CEI emerges as a standard by which stakeholders compare the firm's ethical behaviours to their expectations. Thus, a strong CEI implies congruence with the ethical demands of the firm's stakeholders, resulting in higher levels of satisfaction. In turn, satisfied stakeholders are expected to be more willing to provide their services and resources to the firm, thereby enhancing performance.

A third way in which we plan to fill the gap between corporate identity and a firm's performance is to empirically test our theoretical contention. Our results indicate that firms with a strong CEI achieve a greater degree of SS, and this, in turn, positively affects a firm's financial performance. Also, we have found that CAE and CRE have differential effects. Whereas applied ethics has a positive impact on performance through improved SS, revealed ethics has informational worth and enhances shareholder value directly. However, revealed ethics by itself (i.e. decoupled from ethical initiatives) is not sufficient to boost economic performance.

The remainder of this article is structured as follows. First, we define CEI and its dimensions. Next, we present relevant literature relating to the objectives of this work and our theoretical formulation. We propose a set of hypotheses grounded in the logic of stakeholder theory, through which we analyze the relationship between CEI and the financial performance of firms. Next, we test our hypotheses on a sample of 398 firms from 26 countries. The article concludes with a discussion of the theoretical and practical significance of the study.

## Theoretical framework and hypotheses

Perhaps because of the rapid growth of identity studies, the concept of corporate identity has not been homogeneously defined. The lack of consensus on a precise definition of corporate identity has led to