

# Virtue Rhetoric in Investor Communications: Setting Up for a Letdown?

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*Many companies prominently espouse their virtuous character in communications with investors, with a view toward influencing investor perceptions about the firm's standards of behavior. While there are benefits to investors perceiving an organization to be virtuous, what happens if the firm violates those standards by engaging in unethical behavior? In this study, we use expectancy violations theory to argue that virtue rhetoric sets investors up for disappointment. When an organization claims to be virtuous but then acts unethically, investors respond to the ethics violation more negatively than they would otherwise. We also theorize about scenarios where investors may overlook unethical behavior or intensify their disapproval of it. To test our ideas, we assemble a unique sample of unethical events committed by S&P 500 companies over a 12-year period, combined with analysis of the virtue rhetoric found in their annual letters to shareholders. Our main finding is that investor reaction to unethical behavior is more negative for companies that claimed to be virtuous prior to the violation than for those that did not make such claims. This relationship is less strong when the company has high expected future value.*

**Keywords:** *organizational virtue; expectancy violations theory; strategic framing; unethical behavior*

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Organizations often prominently espouse their virtues, which refer to qualities associated with ethical character (Chun, 2005; Payne, Moore, Bell, & Zachary, 2013). For example, L'Oréal's website unambiguously declares the company's efforts to be socially responsible and their commitment to integrity as a guiding principle. Similarly, in his 2014 letter to shareholders, Hasbro CEO Brian Goldner highlighted company values regarding "product safety, environmental responsibility, and ethical sourcing—in addition to areas like human rights, responsible marketing, philanthropy, and more" (Hasbro, 2014). Some, such as Ben & Jerry's Ice Cream, John Deere, and Lincoln Electric, have made it clear that ethical business practices are an important part of who they are as companies. This does not mean that other firms are less principled, or their values are less important to them, but it does highlight differences in how vocal firms are about their ethical standards (Moss, Neubaum, & Meyskens, 2015).

Current and potential investors develop perceptions about a firm's expected norms of ethical behavior (Chun, 2017). Scholars refer to those expected norms as *organizational virtue orientation* (OVO), which is "an organization's integrated set of values and beliefs supporting ethical character traits and virtuous behaviors" (Payne, Brigham, Broberg, Moss, & Short, 2011: 257). One way firms try to establish investor perceptions about their OVO is by using *virtue rhetoric* in their investor communications. By virtue rhetoric, we mean language and narratives that espouse, and promise adherence to, ethical standards of behavior. Top managers use virtue rhetoric to establish investor perceptions of a firm's OVO, which constitutes a form of strategic framing (Chong & Druckman, 2007; Gurses & Ozcan, 2015). That is, in broad terms, top managers present information about the organization with a view toward influencing the opinions of important stakeholders, including current and potential investors. Managing perceptions, especially those of investors, is an important responsibility of a firm's top management team (Westphal & Zajac, 1998), and this includes managing social evaluations of the firm's ethical values (George, Dahlander, Graffin, & Sim, 2016; MacLean & Behnam, 2010).

We suggest, though, there could be a hidden danger associated with propping up a firm's ethical reputation using virtue rhetoric. Top managers might be tempted to use virtue rhetoric as a means of securing reputational capital and positive investor sentiment (Jonsen, Galunic, Weeks, & Braga, 2015) but fail to meet stakeholder expectations. For example, some top managers use "green talk" in public statements aimed, in part, at satisfying socially responsible investors, without necessarily backing up their talk with concrete actions (Marquis, Toffel, & Zhou, 2016; Siano, Vollero, Conte, & Amabile, 2017). However, there may be potential drawbacks to decoupling symbolic expressions from subsequent substantive actions. We argue that investors may view such virtue rhetoric as positive, but if the firm subsequently violates expectations, they attract outsized negative attention (Floyd, Ramirez, & Burgoon, 1999). Expectancy violations theory (Burgoon, 1993) is an apropos conceptual framework for explaining investor response to unethical behavior because, using virtue rhetoric in their communication with investors, firms establish a baseline of expected behavior (Chun, 2005). If firms subsequently engage in unethical behavior, investors will react intensely, and negatively, in accordance with the degree to which the firm's behavior violates investors' expectations of ethical behavior (Karpoff, Lee, & Martin, 2008; Pfarrer, Decelles, Smith, & Taylor, 2008).

We propose that top managers should be wary of using virtue rhetoric as a symbolic management tactic (Fiss & Zajac, 2006). Despite temptations, they should only use virtue

rhetoric when they are genuine in their intent (Geppert & Lawrence, 2008) and, even still, may expose themselves to investor retribution if violated. We also hypothesize about two boundary conditions that change the nature of the primary relationship under investigation. The first is the firm's expected future performance, where investors may be willing to turn a blind eye to unethical behavior when performance prospects are good. The second is the type of ethical violation, where deviation from expected behavior is most salient for financial misconduct as opposed to other types of ethical violations because financial misconduct has direct and immediate negative consequences for investors.

To test our hypotheses, we develop a comprehensive database of unethical events, which is unique insofar as we include not only illegal behavior but also any behavior that shareholders could construe as not conforming to a high moral standard. We capture firms' virtue rhetoric in investor communications by content analyzing their annual letters to shareholders. We found 1,599 instances of unethical behavior in S&P 500 firms over 11 years, and the results of our analyses largely support our ideas. Investors react more negatively to unethical behavior committed by firms that previously engaged in high, as opposed to low, levels of virtue rhetoric. This relationship is less strong, or even neutral, when investors expect the firm to perform well.

Our study offers several key contributions to the management literature. Foremost, we change the focus of the conversation about unethical behavior from how to manage the message in the wake of misconduct (Bundy & Pfarrer, 2015; Zavyalova, Pfarrer, Reger, & Shapiro, 2012) to managing investor expectations *before* bad behavior occurs. Second, we contribute to the burgeoning literature on OVO by revealing a hidden liability associated with investor perceptions of high OVO—namely, that investors expect the firm to comply with espoused high standards of behavior and will respond strongly when firms fall short of those standards. Our theory and findings also raise the possibility that similar backlash effects may occur among other stakeholder groups, which could impact the company in ways other than financial. Lastly, we add to the body of management research on organizational misconduct and its consequences by examining not just illegal or egregious misconduct but also organizational behavior that deviates from ethical norms.

## Conceptual Development

### *Expectancy Violations Theory*

Expectancy violations theory is a theory of interpersonal communication that describes how individuals respond to unanticipated violations of social norms and expected standards of behavior (Burgoon, 1978). Burgoon (2015) notes that the first key concept in the theory is *expectations*, which represent enduring cognitions about the behavior that others anticipate of an individual. For strangers, expectations derive from social norms, but in established relationships expectations emerge over time through communication and personal interactions. In fact, expectancy violations theory is fundamentally a theory of communication (West & Turner, 2018), so exchanging information between parties to establish norms of behavior is at the core of the theory. Expected behavior can originate from that which is appropriate for a situation or group but more often is about “what we know to be the typical behavior of a specific individual” (White, 2008). These expectations can shift over time as individuals communicate that they are likely to behave in ways that are different from how

they used to behave (Burgoon, 2015). Researchers working in this area have found that expectancy violations elicit negative emotional responses, engender cognitive dissonance, and force audiences to reconcile their expectations with reality (Festinger, 1957; Greifeneder, Bless, & Pham, 2011).

Management scholars have previously applied expectancy violations theory to the firm level (Janney & Gove, 2011; Liu, Liu, Wang, & Xu, 2019). Pertinent to our study, researchers have found that external observers have strong negative reactions when organizational outcomes do not conform to expectations, potentially yielding negative stock market reactions (Karpoff et al., 2008; Karpoff & Lott, 1993) and damaged social evaluations (Pfarrer et al., 2008; Zavyalova et al., 2012). For example, Graffin, Halebian, and Kiley (2016) use expectancy violations theory to explain how investors are likely to respond to various kinds of acquisition announcements based on the acquirer's expected behavior. Several additional studies use expectancy violations theory to explain why the penalty for irresponsible corporate social behavior is greater for firms that have acted responsibly in the past as opposed to those with a record of bad behavior (e.g., Nardella, Brammer, & Surdu, 2020; Price & Sun, 2017; Yoon, Gürhan-Canli, & Schwarz, 2006). In our study, we leverage expectancy violations theory to explain why investors react negatively when firms fail to "walk the talk."

### *Establishing Expectations*

Top managers can use strategic framing to establish a baseline for behavior investors should expect of the firm (Chong & Druckman, 2007). Shareholders and information intermediaries (e.g., analysts and the media) develop ideas about a firm's expected behavior based, in part, on what top managers are communicating to them (Fiss & Zajac, 2006). A core principle of strategic framing is that investment audiences process information in accordance with what they believe to be true about an organization (Goffman, 1974). Researchers have described how top managers use strategic framing to create ideas about norms of behavior to garner investor attention and understanding, including the use of rhetorical devices in communication (Cornelissen & Werner, 2014; Proffitt & Spicer, 2006). For example, top managers might attempt to frame their organizations as being highly innovative (e.g., Google), efficient (e.g., Wal-Mart), or sustainable (e.g., Johnson & Johnson) (Gioia & Chittipeddi, 1991; Maitlis & Lawrence, 2007). Investors, in turn, expect firms to behave in line with the way they have positioned themselves.

Strategic framing aimed at investors (i.e., investor communications, sometimes referred to as "investor relations") is an important managerial endeavor because investors interpret company actions in view of their beliefs about an organization's expected norms (Fiss & Zajac, 2006). In fact, some suggest that one of the primary functions of a top executive is to influence how investors view the organization and its actions (Westphal & Zajac, 1998). Current and potential investors (i.e., external capital markets) are paramount because they directly affect the company's market value. Top managers capable of manipulating investor expectations about the company can potentially change the way investors react to a variety of organizational events, such as earnings announcements or governance adoptions (Pan et al., 2018; Rhee & Fiss, 2014).

Managing investor expectations pertains not only to strategic outcomes but also to managing expectations about the firm's conduct or standards of behavior (Bansal & Clelland, 2004).

In response to numerous corporate scandals, top managers are increasingly attempting to frame their organization as being ethical (Patelli & Pedrini, 2014). By “ethical,” we mean organizations that embody distinguishing characteristics, such as a commitment to moral values, a balanced approach to stakeholders, and leader integrity (Ardichvili, Mitchell, & Jondle, 2009). Executives so frequently engage in behavior designed to establish high ethical expectations that management researchers developed the notion of OVO to describe and measure the extent to which a firm maintains high ethical standards (e.g., McLeod, Moore, Payne, Sexton, & Evert, 2018; Payne et al., 2011). The OVO construct is rooted in ethics virtue theory (Moore, 2005; Moore & Beadle, 2006) and, unlike traditional deontological or consequentialist ethics perspectives, argues that moral character should guide organizations. That is, OVO is concerned with the extent to which firms prioritize and adhere to ethical beliefs as opposed to merely observing rules or avoiding the consequences of bad behavior.

Top managers can use virtue rhetoric in investor communications to raise investor perceptions of the firm’s OVO. In fact, it is relatively costless for them to do so. Unlike rhetoric, however, substantive firm actions that raise outsider perceptions of OVO can incur considerable cost (Cameron, 2003). For example, the SAS Corporation offers generous employee benefits, including auto detailing, on-site health care, and unlimited vacation (Grube, 2019). Ben & Jerry’s exhibits high OVO by using organic ingredients and sustainable manufacturing processes (Ben & Jerry’s, 2020). Warby Parker lives its mission by donating its profits to worthy causes (Lagorio-Chafkin, 2019). Such behaviors serve as valid signals to investors about the firm’s OVO and thus can raise investor expectations regarding ethical conduct. However, ethical initiatives are costly to implement, which is precisely what makes them useful as a signal of expected ethical behavior (Connelly, Certo, Ireland, & Reutzel, 2011). In contrast, virtue rhetoric in investor communications is comparatively costless to implement yet may still influence investor expectations of firm ethical behavior (Bergh, Connelly, Ketchen, & Shannon, 2014; Payne et al., 2013). Considering this possibility, we argue that there is a hidden cost of virtue rhetoric for low OVO firms in the form of strict penalties for those who violate expectations.

## Hypotheses

What happens when companies use virtue rhetoric in their communications with investors to raise investor perceptions of OVO but then engage in unethical behavior? Management scholars have devoted considerable research attention to understanding unethical behavior in the form of corporate misconduct (Harris & Bromiley, 2007). This body of work focuses largely on grievous acts of misconduct. Such actions include financial misconduct (Paruchuri & Misangyi, 2015), employee discrimination (Li, McAllister, Ilies, & Gloor, 2019), and environmental violations (Du, 2015). Firms caught in the act of grievous forms of misconduct face a variety of punishments, such as loss of reputation and high cost of capital, that result in negative investor reactions (Connelly, Ketchen, Gangloff, & Shook, 2016; Paruchuri & Misangyi, 2015). Research suggests that a single instance of corporate misconduct can yield, on average, a 17% drop in stock price (Francis, Philbrick, & Schipper, 1994).

There is, however, a related set of behaviors that fall into a gray area (Greve, Palmer, & Pozner, 2010). These are actions that scholars might not classify as misconduct but that could undermine investor perceptions of the firm’s OVO. For example, organizational attention to

product safety, anticompetitive practices, ambiguous privacy standards, and animal cruelty all represent behaviors that would be uncharacteristic of a firm that frames themselves as being ethical (Chun, 2005). To account for such behaviors, our study moves beyond traditional conceptions of corporate misconduct by defining unethical behavior broadly to include both illegal and unethical acts that investors might deem inconsistent with high OVO.

Some research suggests that top managers may be tempted to engage in virtue rhetoric as a means of boosting investor perceptions, even if their actions do not match their words (Du, 2015; Marquis et al., 2016). The literature on greenwashing shows that managers often exaggerate the supposed environmental benefits of their firm's products or selectively disclose information about their environmental actions (Delmas & Burbano, 2011; Lyon & Maxwell, 2011). This disconnect between actions and words may come about as a result of decoupling, which occurs when firms claim to fulfill investor expectations without making actual changes (Bromley & Powell, 2012). It may also engender symbolic management, which is impression management designed to attain legitimacy and consensus (Lyon & Montgomery, 2015). Likewise, ethics scholars argue that corporate social responsibility (CSR)-related rhetoric is one way top managers attempt to gain firm legitimacy (e.g., Castello & Lozano, 2011; Palazzo & Scherer, 2006). Differences between what firms say and do could also come about from symbolic actions specifically designed to deflect attention away from unethical practices (Marquis & Toffel, 2012). Siano et al. (2017) add that the act of communicating high social standards may even contribute to the disconnect between actions and words. Taken together, these studies show that scholars have devoted considerable attention to the notion that communication with investors may not align with organizational intent (Christensen, Morsing, & Thyssen, 2013).

We extend this body of work by using expectancy violations theory (Burgoon, 1993) to develop ideas about the potential consequences of misalignment. Specifically, we argue that virtue rhetoric in investor communications could have negative market ramifications if the firm subsequently engages in unethical behavior. From an expectancy violations perspective, when firms that use high amounts of virtue rhetoric engage in unethical behavior, investors will form strong negative reactions because the behavior is uncharacteristic of what they believed to be true of the firm (Weber & Mayer, 2011). This scenario reveals an element of potential dishonesty in the communications (Fiss & Zajac, 2006). Investors could, therefore, view the firm's behavior as disingenuous and develop doubts about everything the firm said about itself (Connelly, Miller, & Devers, 2012). These feelings emerge owing to cognitive arousal, wherein investors are highly aware of the unethical behavior and motivated to respond because the behavior engenders such a large discrepancy from the way they believed the firm would act (Burgoon & Walther, 1990). Thus, investors who witness unethical behavior of a firm that previously used high amounts of virtue rhetoric may respond by decreasing their financial position in the firm. Reducing their financial position serves as a means for investors to reconcile cognitive and emotional dissonance (cf. Bachman & Guerrero, 2006).

In contrast, when firms use little or no virtue rhetoric in investor communications, expectancy violations theory would suggest that unethical behavior would draw less investor attention. This is not to say investors will ignore the behavior. However, their response will be relatively less severe than for firms who use high levels of virtue rhetoric because the behavior is not inconsistent with how they have positioned themselves. In other words, the news of unethical behavior in firms with low virtue rhetoric is not cognitively arousing because there

is no obvious disparity between what they are saying and what they are doing (Burgoon, 1993; Burgoon & Walther, 1990). Consequently, the motivation to decrease their financial position in an offending company is likely to be comparatively low when the firm has engaged in low amounts of virtue rhetoric. Thus, we hypothesize the following:

*Hypothesis 1: Virtue rhetoric in investor communications is negatively associated with investor reaction to unethical behavior.*

The paramount concern of most investors is how well the company is performing and expected to perform. Some investors desire to only invest in firms who behave in ways the investor perceives to be ethical, but most are concerned with one chief outcome: financial returns. Given the importance of financial returns to most investors, we expect that a company's expected future performance could change the way investors respond to unethical behavior. Jones and Davis (1965) argue that self-interested individuals sometimes develop biased attributions based on what they call "hedonic relevance" when an unexpected event has implications for their own welfare. Such biases allow individuals to process information and develop attributions in ways that avoid distress (Kelley & Michela, 1980).

Consistent with these ideas, extant research shows that expectations of firm performance influence investor sentiment and how investors react to relevant news (e.g., Edmans, Garcia, & Norli, 2007; Palomino, Renneboog, & Zhang, 2009). High expectations of future performance will dampen the negative relationship between virtue rhetoric and investor reaction to unethical behavior because investors in this situation are less concerned about, or perhaps even blinded to, the expectancy violation. Individuals suffer biases that foster selective attention and self-serving behavior, skewed information interpretation, and imputation of missing or inconclusive evidence (Fiske & Taylor, 2008). This often includes "alter[ing] their fundamental views about what is fair or right in a way that benefits their interests" (Dahl & Ransom, 1999: 703).

We suggest that investors will experience a diminished expectancy violation between high levels of virtue rhetoric and subsequent unethical behavior when they expect the firm to perform well in the future. As such, they will not respond with reduced stock positions, which alleviates downward pressure on the firm's stock price. In short, performance expectations surpass expectancy violations.

Conversely, low expectations of future performance could exacerbate investor feelings of expectancy violation when an organization that uses a high amount of virtue rhetoric in their investor communications subsequently engages in unethical behavior. In this scenario, virtue rhetoric becomes salient to investors as they evaluate the unethical behavior because the firm does not have an economic redeeming factor. In the absence of information biasing investors toward a self-serving decision (i.e., high expected future firm performance), they are more likely to see the expectancy violation for what it is and less likely to impose biases excusing the behavior. Thus, when expected future performance is low, an expectancy violation between virtue rhetoric and unethical behavior will adversely affect investors relative to when future performance expectations are high, imposing downward pressure on the firm's stock price. We, therefore, hypothesize the following:

*Hypothesis 2: The negative relationship between virtue rhetoric in investor communications and investor reaction to unethical behavior is weaker when expected future performance is high than when it is low.*

We also suggest that the primary relationship under investigation may be strongest in the case of financial misconduct, as opposed to other types of ethical violations. This is because firms engage in a variety of types of unethical behavior that affect some stakeholders more than others. Some types of unethical behavior may have special consequences for groups of stakeholders, such as employee safety or environmental infractions, which clearly hurt internal stakeholders and communities. Ethical violations that directly influence investors will be most important to the extent to which investors react negatively to the behavior. Consistent with hedonic relevance, when an event affects a person's welfare, it biases his or her attributions for the event (Jones & Davis, 1965). Psychological arousal and the motivation to respond to an event increases with instrumental salience (Bundy, Shropshire, & Buchholtz, 2013). Individuals are especially aware of, and responsive to, issues or events that threaten their personal well-being (Polletta & Jasper, 2001).

Financial misconduct has direct and immediate negative consequences for investors (Zhang, Bartol, Smith, Pfarrer, & Khanin, 2008). Financial misconduct misleads shareholders into believing a firm is more profitable or valuable than it is. Describing their investigation of financial misconduct, Arthaud-Day, Certo, Dalton, and Dalton (2006: 1125) note that they focus on "aggressive accounting practices, intentional and unintentional misuse of facts, misinterpretation or oversight of accounting rules, and fraud." These authors describe how such actions are particularly harmful to investors because they constitute a breach of shareholder trust. Similarly, Shi, Connelly, and Hoskisson (2017: 1270) observe that financial misconduct "occurs when managers take actions that deceive investors or other key stakeholders" and "often involves corruption, lying about facts, failure to disclose material information, falsifying information about the firm's performance, or covering up systematic problems." For these violations, investors will experience a strong expectancy violation resulting from high levels of virtue rhetoric in investor communications prior to the violation and will respond by aggressively reducing their stock position, pushing share prices down.

Alternatively, unethical behavior that engenders nonfinancial forms of misconduct could temper investors' expectancy violations. This is because investors perceive other ethical violations as distal and unlikely to undermine their financial well-being (Kassinis & Vafeas, 2002). For example, environmental violations and employee discrimination issues are more proximal to society and employees than to investors, and their bottom-line effects for investors are ambiguous and varied (Bromiley & Marcus, 1989). In these scenarios, investors may be less concerned about the unethical behavior, so that virtue rhetoric in investor communications prior to the behavior has little effect. Thus, we hypothesize the following:

*Hypothesis 3: The negative relationship between virtue rhetoric in investor communications and investor reaction to unethical behavior is stronger for financial misconduct than it is for other types of unethical behavior.*

## Methodology

### *Research Context*

Our study is about the predictive nature of virtue rhetoric in investor communications. There are a variety of ways that firms and their top managers can communicate with investors. These include the company's website, brochures designed for potential investors,

“roadshows” aimed at special groups of investors, and formal SEC filings. To identify virtue rhetoric in investor communications, we focus on letters to shareholders, which anchor the firm’s annual report. We choose this research context to examine our main predictor for several reasons: Letters to shareholders (1) are accessible and understandable, (2) reflect the sentiment of top managers, (3) sway investor perceptions, and (4) contain varying levels of virtue rhetoric.

The letter to shareholders is the most easily understood aspect of the annual report. The annual report itself is a dense, lengthy document containing business descriptions, possible risk factors, financial information, and corporate disclosures. The letter to shareholders, though, provides a summary of business activities during the previous year, explication of ongoing and upcoming opportunities and challenges, and thoughts about the leadership and culture of the company (Kohut & Segars, 1992). CEOs use it to communicate their attitudes, beliefs, and values about company operations and performance (Short & Palmer, 2003). As such, the letter to shareholders is a more accessible source of company information than other legally required documents and the most digestible element of the annual report (Gibson & Schroeder, 1990).

The CEO typically writes and signs the letter to shareholders. This annual letter is the main opportunity for executives to explain the results of operations and performance and establish the firm’s strategic priorities going forward (Gamache, McNamara, Mannor, & Johnson, 2015). As a result, management researchers have long examined the usefulness of shareholder letters as a means for CEOs to communicate with shareholders (e.g., Abrahamson & Park, 1994; Bettman & Weitz, 1983; Craig & Amernic, 2011). This body of work reveals that shareholder letters provide important insight into executive perceptions of their organization, its performance, and the environment in which it operates (Barr, 1998; Prasad & Mir, 2002). In fact, scholars working in this area contend that letters to shareholders reflect more than simply the perspective of the CEO but rather reveal a socially negotiated perspective shared by the CEO and other top management team members (Cho & Hambrick, 2006; D’Aveni & MacMillan, 1990). For example, Segars and Kohut (2001: 535) conclude that “among the many forms of communication produced by firms, the Chief Executive Officer’s (CEO) letter to shareholders is perhaps the most strategic in conveying the well-being and future direction of the enterprise.”

One key finding in prior research is that shareholder letters matter to investors (Abrahamson & Amir, 1996; Kohut & Segars, 1992; Patelli & Pedrini, 2014). This is likely because the statements CEOs and other top executives put forward in shareholder letters often portend future firm actions (e.g., Cho & Hambrick, 2006; Marcel, Barr, & Duhaime, 2011). Studies in management, accounting, and finance together suggest that letters to shareholders contain important information that can significantly influence buying decisions in capital markets (e.g., Bühner & Möller, 1985; Cong, Freedman, & Park, 2014; Smith & Taffler, 2000). For example, Abrahamson and Amir (1996) found that investors use information presented in shareholder letters to understand the quality and temporality of a firm’s operations and earnings. Similarly, Asay et al. (2018) find that investors react strongly to these annual letters and are especially attuned when CEOs use personal pronouns in the letter. Moreover, many investors rely on securities analysts, who also attend to the information provided in shareholder letters when making buy/sell recommendations (Previts, Bricker, Robinson, & Young, 1994).

Anecdotally, CEOs appear to use virtue rhetoric in their letters to shareholders to establish expectations about the firm's standards of ethical conduct. For example, in their 2011 letter to shareholders, executives of Regions Bank included a number of statements referencing their ethical values, such as "We see a commitment to fair and responsible banking as an important part of our dedication to providing the very best customer service" and "Beyond complying with fair lending laws, our obligation to serve our customers . . . is rooted in our values, our trust and integrity, and our business strategy." In contrast, some firms use little or no virtue rhetoric in their letters to shareholders. For instance, executives at other banks, including Northern Trust and BNY Mellon, focused investor attention on growth initiatives, intellectual talent, and innovation in their 2011 letters to shareholders, with little mention of the ethical characteristics associated with high OVO.

### *Sample*

Our hypotheses are about how investors respond to unethical behavior, so we derive our sample from newsworthy organizational events reported in the press. We found unethical events by searching media articles using the "Negative Mentions" option in Factiva. We searched for S&P 500 firms during the years 2001-2012, inclusive. We included firms in our sample only for the years in which they appeared in the S&P 500 during our sampling time frame.

One of the co-authors and a doctoral student in management examined the articles, each handling about half the sample. Initially, they manually examined the headline, and the first few paragraphs when the headline was ambiguous, of over 500,000 articles. For each event covered by these articles, the coders decided whether it described an unethical event or not. We defined an unethical event as conduct perceived to be outside of legal or professional standards. To establish a baseline for decision making, the two coders and another co-author initially examined events and discussed protocols for deciding whether the event fit our definition of being unethical. They iteratively repeated this process over several weeks, honing in on their common understanding of the definition, until there was mutual agreement. Using this process, three people therefore jointly considered and reached consensus about the ethicality of more than 300 events before the two coders began to work independently to code articles. In total, the coders identified 83,814 media articles related to 1,599 unethical events committed during our sampling window; the final sample only includes events for which complete data (i.e., all predictor and control variables described below) were available. Following the sample identification process, the two coders resampled and recoded a subset of 200 media articles and calculated an interrater reliability of 0.97 using Holsti's (1969) method. This reveals our coders agreed on the inclusion or exclusion of an unethical event in 97% of the resampled articles, suggesting high interrater reliability (cf. Ellis, 1994).

For each unethical event identified, the coders used the news articles about the event to record the date of first announcement and type of violation; how the type of violation was coded is discussed in our description of control variables. As a reliability check, the two coders considered a randomly selected subset of 200 unethical events and found interrater reliability about the date of first announcement and type of violation was above 0.98 (Holsti, 1969).

## Measures

*Dependent variable.* We measured investor reaction using *cumulative abnormal returns* (CAR) attributed to the announcement of unethical behavior. We generated CARs for the focal events in our sample from the Eventus database. This database mathematically defines CAR as the sum of the difference between the rate of return of the share price of firm *i* at time *t* and the expected market return at time *t* for window of time *n* in days. Following McWilliams and Siegel (1997), we restricted our window of time to 1 day to avoid error from confounding events. This event window is consistent with prior research examining investor reaction to misconduct (e.g., Schuler, Shi, Hoskisson, & Chen, 2017; Wassmer & Dussauge, 2012).

A key element of CAR is that it represents the change in stock price that occurs as a result of a specific event. This measure is independent of the absolute level of the share price. We rely on CAR for the dependent variable because we theorize about and measure the investor penalty associated with unethical behavior. Investors will generally place their money in firms they believe have a strong future. Therefore, the baseline level of investment (i.e., share price) will certainly be low for firms that have poor future prospects. We are less concerned, though, with this absolute level of investment than we are with the relative change in investment on the day an unethical event occurs.

A fundamental assumption of this operationalization is that investors will react quickly to announcement of an ethical violation. We do not capture what firms are saying or doing in the wake of announcing an unethical event (Zavyalova et al., 2012). Thus, we do not consider the extent to which top managers are apologetic or obstinate about the violation. Further, we do not know how investors react over time. It could be, for instance, that firms adopt different communication strategies in the aftermath of an unethical event that could mitigate or exacerbate the consequences of expectancy violation. Our use of CAR cannot capture these effects, but rather it is limited to investigation of immediate investor response to a specific announcement.

*Independent variable.* We measured *virtue rhetoric* in letters to shareholders written prior to each unethical event. We focus on virtue rhetoric prior to the event because we are interested in how firms frame investor perceptions of OVO before a violation occurs. To capture virtue rhetoric, we used computer-aided text analysis (i.e., content analysis), where a software program compares a corpus of texts against dictionaries containing words and phrases that characterize constructs or topics of interest (Krippendorff, 2004). Content analysis is a qualitative analytical technique that identifies and categorizes language upon which scholars may draw inferences (Short & Palmer, 2008). Applied to firm-level narratives such as letters to shareholders, content analysis is a common means of unobtrusively assessing important constructs in strategic management, such as executive cognitions (Gamache et al., 2015) and organizational ethics (Daly, Pouder, & Kabanoff, 2004).

To extract virtue rhetoric from the narratives in letters to shareholders, we identified language that spoke to one of the six organizational virtue dimensions described by Chun (2005). Specifically, we used the computer-aided text analysis word lists for conscientiousness, courage, empathy, integrity, warmth, and zeal developed by Payne et al. (2011). In Table 1, we report the word lists for each dimension and provide examples of their use in shareholder letters. We applied these dictionaries to our sample of shareholder letters using Linguistic

**Table 1**  
**Word Lists and Example Rhetoric for Virtue Framing Dimensions**

| Virtue Dimension  | Word List                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                          | Example                                                                                                                                                                                                                                                                                                          |
|-------------------|--------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| Conscientiousness | Accomplished, accountable, accurate, attentive, at-work, businesslike, bustling, busy, careful, certain, confident, conscientious, conscionable, customer-centric, demanding, dependable, detailed, diligent, dutiful, effective, efficacious, efficient, engaged, hard-working, heedful, impressive, judicious, laudable, meticulous, mindful, notable, painstaking, persistent, planning, praiseworthy, prepared, productive, protected, proud, regardful, reliable, reputable, responsible, scrupulous, solicitous, stable, steadfast, steady, thorough, tireless, unflinching, value-added, vigilant, watchful | At the corporate board and management levels, risk management now involves much greater <i>attention to detail</i> . Risk reviews are increasingly <i>thorough</i> , risk disclosures are deeper and any executive <i>responsible</i> for risk taking is the recipient of extensive oversight. (JP Morgen, 2011) |
| Courage           | Achievement-oriented, adept, aggressive, aspiring, assertive, bold, brave, capable, climbing, competent, courageous, daring, desirous, determined, effectual, enduring, enterprising, entrepreneurial, exploitative, foremost, goal-oriented, hardy, heroic, hungry, impenetrable, in-charge, knowledgeable, leading, overcoming, prevailing, ready, self-reliant, skilled, staunch, stout, striving, strong, tenacious, topmost, top-ranked, valiant, valorous, willful                                                                                                                                           | In 2009, we accelerated the next <i>bold</i> move of our company's history and began <i>aggressively</i> acquiring <i>leading</i> positions in almost all of the nation's big liquids-rich plays. . . . (Chesapeake Energy, 2012)                                                                                |
| Empathy           | Accepting, aidful, assuring, caring, charitable, compassionate, considerate, empathetic, encouraging, forgiving, helpful, humane, kind, listening, merciful, patient, ready-to-help, supportive, sympathetic, thoughtful, tolerant, understanding, well-being                                                                                                                                                                                                                                                                                                                                                      | While growing our businesses, we also took <i>thoughtful</i> , disciplined actions to streamline and improve our cost structure. (Johnson & Johnson, 2009)                                                                                                                                                       |
| Integrity         | Authentic, believable, credible, creditable, decent, devoted, earnest, equitable, ethical, even-handed, fair, faithful, forthright, genuine, highly-respectable, honest, honorable, ingenuous, law-abiding, lawful, loyal, objective, principled, resolute, respectable, sincere, socially-responsible, transparent, true, trusted, trustworthy, trusty, truthful, upright, upstanding, values-based, virtuous                                                                                                                                                                                                     | Raytheon's comprehensive <i>ethics</i> education program leads the industry and supports the company's <i>values</i> , reinforcing the highest standards of <i>ethical</i> conduct in all of our business activities. (Raytheon, 2012)                                                                           |
| Warmth            | Agreeable, amiable, benevolent, cordial, courteous, diplomatic, familiar, friendly, generous, genial, gracious, grateful, hospitable, neighborly, open, pleasant, polite, receptive, straightforward, tender                                                                                                                                                                                                                                                                                                                                                                                                       | . . . our employees are determined to provide you with prompt, courteous, and excellent service. (DirectTV, 2009)                                                                                                                                                                                                |
| Zeal              | Alive, anxious, ardent, astonishing, avid, breakthrough, captivating, compelling, creative, dazzling, dogged, dynamic, eager, electrifying, energetic, enthusiastic, enticing, exceptional, excited, exciting, extraordinary, fabulous, fascinating, fervent, fiery, gung-ho, impassioned, ingenious, inspiring, intriguing, invigorating, lively, novel, passionate, provocative, reinvigorated, renewed, resourceful, revolutionary, rousing, spirited, stimulating, stirring, thrilling, transformative, trendsetting, unconventional, unprecedented, vehement, vigorous, visionary, vivacious, vivid, zealous  | The 134,000 people who make up Gap Inc. are <i>inspired</i> by our past and <i>passionate</i> about winning. (Gap, 2009)                                                                                                                                                                                         |

Inquiry and Word Count software (Pennebaker, Booth, & Francis, 2007). We calculated word count scores for virtue rhetoric related to each of the six dimensions, summed them into an aggregate measure, and divided this measure by the number of words in the letters (Payne et al., 2011).

Descriptively, our measure of virtue rhetoric appears to demonstrate the kind of variance we expected. Using this operationalization, a simple mixed-effects growth model of our data revealed a steady increase in virtue rhetoric in letters to shareholders across firms over time (Bliese & Ployhart, 2002). Specifically, firms in our sample increase virtue rhetoric about 2% annually, which extrapolates to a 24% overall increase in virtue rhetoric during our sampling timeframe. Thus, top managers appear to be increasingly using virtue rhetoric in their letters to shareholders over time. Our analysis also reveals significant within-firm variance in virtue rhetoric from year to year. That is, for any given firm, there appears to be significant change in the extent to which managers use virtue rhetoric in their letter to shareholders from one year to the next. This is important because we sought to capture whether top managers were dynamically using, or not using, virtue rhetoric to manage investor expectations about OVO.

*Moderators.* We measured *expected future performance* using the firm's market-to-book ratio, which is the market value of equity divided by book value of equity (Fama & French, 1992). Similar to Tobin's *q*, the market-to-book ratio reflects the premium (or discount) investors assign to a firm based on perceived performance potential (Daily, Certo, & Dalton, 2000) and thus has become a common measure of expected future performance in management research (e.g., Cannella, Jones, & Withers, 2015; Feldman & Montgomery, 2015).

We measured *financial misconduct* as a dichotomous variable coded as "1" if an unethical event was determined to be financially based and "0" otherwise. Consistent with prior research (e.g., Fich & Shivdasani, 2007), a financial violation is specified under Rule 10b-5 of the U.S. Securities and Exchange Act of 1934, which makes it illegal for anyone to directly or indirectly use any measure to defraud, make false statements, omit relevant information, or otherwise conduct business operations that would deceive another person in transactions involving stock and other securities. The intention of Rule 10b-5 is to enforce actions against firms that have "intent to deceive, manipulate, or defraud with misstatements of material fact made in connection to financial condition, solvency, and profitability" (Fich & Shivdasani, 2007: 311). These coding decisions were fairly straightforward because there is a rich body of management research focused on financial misconduct (Connelly, Shi, Walker, & Hersel, 2020; Shi et al., 2017) with fairly consistent operationalizations aimed at capturing events such as "reporting inflated profits, asset fabrication, issuing misleading statements, asset embezzlement, insider trading, illegal share buybacks, stock price manipulation, and providing illegal guarantees" (Li, Shi, Connelly, Yi, & Qin, 2020: 10).

Using the guidelines discussed above, we identified 408 investor-related violations in our sample; this amounts to approximately 26% of the total number of unethical events in the sample. An example of a financial violation is an article about an institutional investor who filed a lawsuit against Boston Scientific, accusing the company of misleading shareholders about the benefits and rosy projections for its cardiac rhythm management business. An example of a nonfinancial violation is an article about a company-led investigation revealing that Best Buy CEO Brian Dunn engaged in an "extremely close personal relationship with a 29-year-old subordinate that negatively impacted the work environment" (Wall Street Journal, 2012).

**Table 2**  
**Sample Frequency Table of Types of Unethical Behavior by Year**

| Type of Unethical Behavior             | 2001 | 2002 | 2003 | 2004 | 2005 | 2006 | 2007 | 2008 | 2009 | 2010 | 2011 | 2012 | Total |
|----------------------------------------|------|------|------|------|------|------|------|------|------|------|------|------|-------|
| Anticompetitive practices              | 11   | 70   | 67   | 46   | 47   | 23   | 10   | 12   | 13   | 15   | 18   | 16   | 348   |
| Bribery, corruption, and tax avoidance | 0    | 6    | 11   | 16   | 13   | 6    | 4    | 7    | 12   | 11   | 25   | 13   | 124   |
| Consumer concerns                      | 10   | 82   | 43   | 45   | 54   | 33   | 25   | 10   | 7    | 11   | 19   | 32   | 371   |
| Discrimination/harassment              | 6    | 11   | 9    | 7    | 10   | 8    | 5    | 2    | 3    | 0    | 5    | 3    | 69    |
| Employee fairness                      | 1    | 33   | 28   | 23   | 28   | 21   | 9    | 7    | 7    | 2    | 6    | 5    | 170   |
| Environmental safety                   | 1    | 8    | 6    | 9    | 14   | 12   | 2    | 4    | 4    | 3    | 3    | 3    | 69    |
| Fraud/misrepresentation                | 10   | 64   | 53   | 53   | 55   | 31   | 23   | 9    | 7    | 7    | 22   | 36   | 370   |
| Other                                  | 1    | 8    | 18   | 9    | 9    | 6    | 3    | 0    | 0    | 1    | 5    | 1    | 61    |
| Total                                  | 40   | 283  | 238  | 209  | 231  | 141  | 83   | 52   | 53   | 52   | 103  | 114  | 1599  |

*Controls.* We control for salient event-, firm-, and industry-level factors that might affect investor reaction to unethical behavior. To account for firm size effects, we control for the natural log (owing to skewness) of the *number of firm employees* and the natural log of *total sales* (Pfarrer, Pollock, & Rindova, 2010). We also control for different indicators of firm performance, including *debt-to-equity*, *current ratio*, and *return on equity*. We control for the natural log of *shares outstanding* and *average trading volume* to account for differences in trading patterns between growth and income investments (Skinner & Sloan, 2002). We also control for *analyst recommendations*, which may further explain why investor reactions might vary across similar violations (Nayyar, 1995). Consistent with research on corporate misconduct (e.g., Zorn, Shropshire, Martin, Combs, & Ketchen, 2017), we control for institutional ownership, which is the percent of outstanding shares held by institutional investors (Hartzell & Starks, 2003). A history of unethical behavior could affect our results, so we used data in our sample to control for the number of prior *firm violations* and prior *industry violations* in the previous year, as well as the number of *days since the last violation*.

We controlled for differences in *type of unethical behavior* with a set of dummy variables representing eight different categories of unethical behavior derived from our inductive manual search for unethical events. This process began with the two coders independently creating descriptive violation types. They then worked together with another co-author to collectively reconcile these into eight different types with the goal of maximizing within-type homogeneity and between-type heterogeneity. Although some types rarely occur, they are distinct enough to warrant individual controls. The resultant types of ethical violations were anticompetitive practices, bribery/corruption/tax avoidance, consumer concerns, discrimination/harassment, employee fairness, environmental safety, fraud/misrepresentation, and a final “other” category that included a sporadic set of violations such as animal cruelty and conflicts of interest. This set of dummy variables is distinct from our financial misconduct moderator because ethical violations within some categories encompass both financial and nonfinancial violations. In Table 2, we show the distribution of each type across the years of our sampling time frame.

Media responses can also shape investor reactions, so we control for this in two ways. First, we include a measure of *media coverage*, which is the number of media articles related

to the unethical behavior released during our event window (Pollock & Rindova, 2003). Second, using a unique measure, we control for the social media prominence of unethical events. To do so, we calculate the number of abnormal hits a firm received on Google (including web searches and news) on the day of the unethical event. Akin to the methodology for calculating CAR, we calculated the abnormal number of hits by collecting the daily hit counts for each company every day for the 90 days prior to the unethical event. From this we calculated the average number of daily hits for the firm and subtract it from the number of hits on the day of the unethical event. Google became the top search engine around 2004, so for unethical events that occurred within the first few years of our study the number of Google hits was low or zero.

Finally, we control for time in two ways. First, we account for time between release of the shareholder letter and the unethical event. The release of a shareholder letter coincides with the release of the firm's annual report, which the Securities and Exchange Commission (SEC) requires within the first fiscal quarter. Thus, we include a set of dummy variables denoting the *time to violation*, which accounts for the number of quarters between the letter to shareholders and when the ethical violation occurred. Second, we include a set of dummy variables representing the *year* the ethical violation occurred.

## Results

Many firms in our sample committed multiple violations, so our data nests observations within firms. In addition, some unethical events in our data are repetitions or extensions of prior unethical events (e.g., an individual could accuse a CEO of sexual harassment at one time but sometime later a different alleged victim could accuse the same CEO of the same violation). To ensure we accounted for the possibility that an unethical event could be a repetition or extension of a prior unethical event, the two coders and another co-author established a criterion such that they identified whether an unethical event was related to a prior event. Coding for these (which were about one third of the total observations) allowed us to model investor reactions to unethical behavior using fixed effects regressions with two-way robust standard errors, while controlling for both within-firm and related-violation effects (Peterson, 2009; Wooldridge, 2002). In Table 3, we show descriptive statistics and bivariate correlations for our variables.

In Table 4, we report results of the hypothesis tests, with control variables in the first column. In Hypothesis 1, we predicted that virtue rhetoric prior to the occurrence of unethical behavior would be negatively associated with investor reaction to the behavior. The results of Model 2 ( $\beta_{\text{Virtue Rhetoric}} = -42.14, p \leq 0.05$ ) and Model 3 ( $\beta_{\text{Virtue Rhetoric}} = -98.41, p \leq 0.05$ ) lend support to this hypothesis. In Hypothesis 2, we predicted that expectations of future performance would dampen the negative relationship between virtue rhetoric and investor reaction to unethical behavior. The results of Model 3 ( $\beta_{\text{MTB}} = -0.29, p > 0.05$ ;  $\beta_{\text{Virtue Rhetoric*MTB}} = 39.62, p \leq 0.05$ ) support this hypothesis. Finally, in Hypothesis 3 we predicted that the negative relationship between virtue rhetoric and investor reaction to unethical behavior would be stronger in the case of financial misconduct as opposed to nonfinancial misconduct. The results of Model 3 ( $\beta_{\text{Financial Violation}} = 0.56, p > 0.05$ ;  $\beta_{\text{Virtue Rhetoric*Financial Violation}} = -57.00, p > 0.05$ ), however, do not support this hypothesis.

As shown in Figure 1, the relationship between virtue rhetoric and investors' response to unethical behavior is different for firms that have higher expectations for future performance

**Table 3**  
**Descriptive Statistics and Bivariate Correlations**

| Variables                              | M      | SD     | 1     | 2     | 3     | 4     | 5     | 6     | 7     | 8     | 9     | 10    | 11    | 12    | 13    | 14    | 15   | 16    | 17    |
|----------------------------------------|--------|--------|-------|-------|-------|-------|-------|-------|-------|-------|-------|-------|-------|-------|-------|-------|------|-------|-------|
| 1. Total employees                     | 9.33   | 2.13   |       |       |       |       |       |       |       |       |       |       |       |       |       |       |      |       |       |
| 2. Total sales <sup>a</sup>            | 23.62  | 1.07   | -0.04 |       |       |       |       |       |       |       |       |       |       |       |       |       |      |       |       |
| 3. Debt-to-equity                      | 0.68   | 38.88  | 0.01  | 0.06  |       |       |       |       |       |       |       |       |       |       |       |       |      |       |       |
| 4. Current ratio                       | 1.00   | 3.99   | 0.05  | -0.31 | 0.00  |       |       |       |       |       |       |       |       |       |       |       |      |       |       |
| 5. Return on equity                    | 0.14   | 0.92   | 0.01  | 0.07  | 0.20  | -0.02 |       |       |       |       |       |       |       |       |       |       |      |       |       |
| 6. Shares outstanding <sup>a</sup>     | 20.62  | 1.24   | -0.06 | 0.68  | 0.01  | -0.22 | 0.06  |       |       |       |       |       |       |       |       |       |      |       |       |
| 7. Average trading volume <sup>a</sup> | 21.03  | 1.19   | -0.10 | 0.54  | -0.01 | -0.16 | 0.00  | 0.87  |       |       |       |       |       |       |       |       |      |       |       |
| 8. Analyst recommendations             | 2.34   | 0.43   | -0.04 | -0.24 | -0.02 | 0.08  | -0.08 | -0.40 | -0.37 |       |       |       |       |       |       |       |      |       |       |
| 9. Institutional investors             | 0.65   | 0.13   | -0.03 | -0.25 | -0.03 | 0.09  | 0.02  | -0.37 | -0.15 | 0.06  |       |       |       |       |       |       |      |       |       |
| 10. Prior firm violations              | 17.66  | 21.84  | -0.02 | 0.46  | 0.02  | -0.14 | 0.02  | 0.54  | 0.54  | -0.24 | -0.08 |       |       |       |       |       |      |       |       |
| 11. Prior industry violations          | 32.92  | 30.15  | -0.08 | -0.01 | 0.03  | -0.02 | 0.02  | 0.23  | 0.14  | -0.03 | 0.17  | -0.15 | -0.17 |       |       |       |      |       |       |
| 12. Days since prior violation         | 199.97 | 386.65 | -0.01 | -0.12 | -0.02 | 0.07  | 0.01  | -0.17 | -0.08 | 0.03  | 0.17  | -0.15 | -0.17 | -0.09 |       |       |      |       |       |
| 13. Media coverage                     | 52.42  | 60.21  | -0.03 | 0.47  | 0.04  | -0.11 | 0.00  | 0.55  | 0.57  | -0.15 | -0.22 | 0.45  | 0.12  | 0.05  | 0.10  |       |      |       |       |
| 14. Abnormal search traffic            | 3.35   | 13.87  | 0.01  | -0.01 | 0.02  | 0.00  | 0.05  | 0.02  | 0.04  | -0.01 | 0.06  | 0.05  | 0.00  | 0.02  | -0.05 | -0.01 |      |       |       |
| 15. Virtue rhetoric <sup>b</sup>       | 0.90   | 0.33   | 0.07  | -0.02 | -0.00 | -0.04 | -0.02 | -0.01 | -0.04 | -0.10 | -0.05 | -0.00 | -0.01 | 0.02  | -0.03 | 0.05  | 0.10 | 0.10  |       |
| 16. MTB ratio                          | 1.83   | 1.58   | 0.00  | -0.18 | -0.04 | 0.06  | 0.13  | 0.17  | 0.16  | -0.37 | -0.06 | -0.03 | 0.15  | -0.03 | 0.05  | 0.10  | 0.10 | 0.05  | 0.05  |
| 17. Financial violation                | 0.26   | 0.44   | 0.02  | -0.03 | -0.02 | -0.02 | 0.02  | 0.04  | 0.04  | 0.08  | 0.02  | 0.02  | 0.03  | 0.04  | 0.02  | 0.04  | 0.03 | 0.00  | -0.03 |
| 18. 1-day CAR <sup>b</sup>             | -0.16  | 5.14   | 0.01  | 0.00  | 0.00  | 0.03  | 0.02  | -0.01 | -0.01 | -0.01 | 0.02  | 0.02  | -0.01 | -0.00 | -0.01 | -0.03 | 0.00 | -0.02 | -0.03 |

*Note:* Values equal to or greater than |0.03| fall within a 95% confidence interval.

<sup>a</sup>Values reported in millions.

<sup>b</sup>Values reported in percentage \*100 to facilitate interpretation.

**Table 4**  
**The Effect of Virtue Rhetoric on Investor Reactions to Unethical Behavior**

| Variables                             | Model 1        | Model 2         | Model 3         |
|---------------------------------------|----------------|-----------------|-----------------|
| Intercept                             | 1.16 (4.29)    | 1.37 (4.35)     | 1.49 (4.43)     |
| Total employees                       | −0.07 (0.08)   | −0.07 (0.08)    | −0.09 (0.08)    |
| Total sales                           | −0.15 (0.14)   | −0.16 (0.14)    | −0.09 (0.16)    |
| Debt-to-equity                        | −0.00** (0.00) | −0.00** (0.00)  | −0.00* (0.00)   |
| Current ratio                         | 0.02 (0.02)    | 0.02 (0.02)     | 0.03 (0.02)     |
| Return on equity                      | 0.24** (0.06)  | 0.24** (0.06)   | 0.22** (0.06)   |
| Shares outstanding                    | 0.30 (0.25)    | 0.31 (0.25)     | 0.19 (0.29)     |
| Average trading volume                | −0.18 (0.23)   | −0.17 (0.23)    | −0.13 (0.23)    |
| Analyst recommendations               | 0.15 (0.40)    | 0.11 (0.40)     | 0.21 (0.46)     |
| Institutional ownership               | 0.74 (1.14)    | 0.81 (1.15)     | 0.71 (1.16)     |
| Prior firm violations                 | 0.01 (0.01)    | 0.01 (0.01)     | 0.01 (0.01)     |
| Prior industry violations             | −0.00 (0.01)   | −0.00 (0.01)    | −0.00 (0.01)    |
| Days since last violation             | −0.00 (0.00)   | −0.00 (0.00)    | −0.00 (0.00)    |
| Media coverage                        | −0.00 (0.00)   | −0.00 (0.00)    | −0.00 (0.00)    |
| Abnormal search traffic               | −0.03* (0.01)  | −0.02* (0.01)   | −0.02* (0.01)   |
| Virtue rhetoric                       |                | −42.14* (24.21) | −98.41* (50.63) |
| Market-to-book (MTB) ratio            |                |                 | −0.29 (0.23)    |
| Financial violation                   |                |                 | 0.56 (0.84)     |
| Virtue Rhetoric * MTB                 |                |                 | 39.62* (19.98)  |
| Virtue Rhetoric * Financial Violation |                |                 | −57.00 (75.21)  |
| <i>N</i>                              | 1,599          | 1,599           | 1,599           |
| <i>F</i> value                        | 1.37           | 1.37            | 1.51*           |

*Note:* Dummy variables for violation year, time to violation, and type of unethical behavior included in the model but not reported; *p* values for independent and moderator variables reflect one-tailed tests.

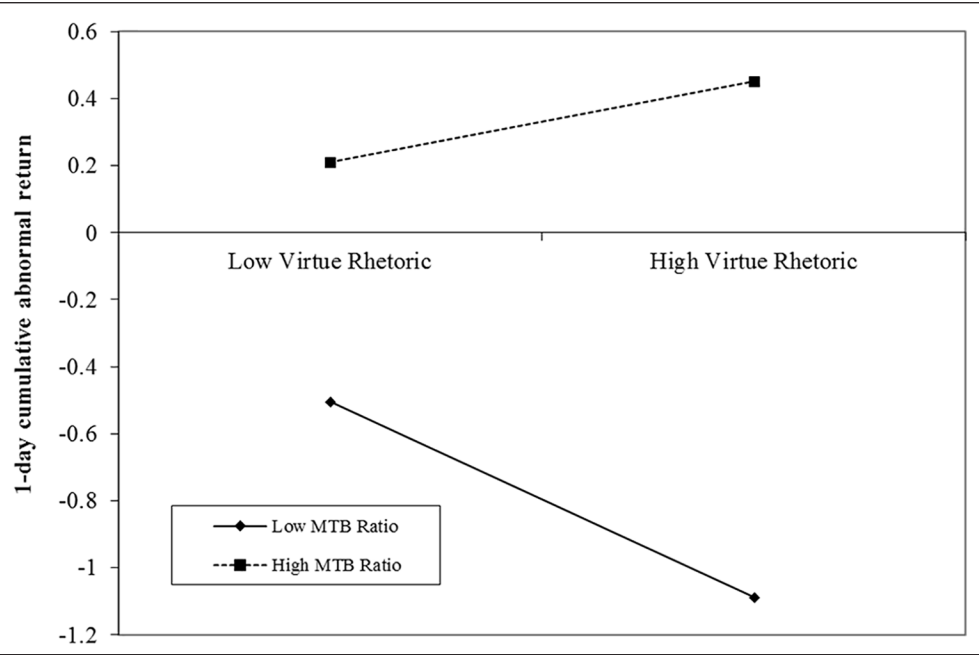
\* $p \leq 0.05$ , \*\* $p \leq 0.01$ .

than for those with lower expectations. For firms with lower expectations, our main relationship holds ( $t = -1.95, p \leq 0.05$ ). Investors have an increasingly negative reaction to unethical behavior as these firms engage in a heightened amount of virtue rhetoric. A different story emerges for firms with expectations for high levels of future performance, however. For these firms, investors appear to attend less to the expectancy violation brought on by unethical behavior so that the main relationship is weaker. In fact, a simple slopes test reveals that the point estimates for high future value firms in our sample are not statistically different ( $t = 0.15, p > 0.05$ ), suggesting that investor reactions to unethical behavior is roughly the same no matter how much virtue rhetoric firms used.

### *Supplementary Analyses*

*Organizational narratives.* One could argue that our findings may be an artifact that is specific to our research context of shareholder letters and not necessarily reflective of the general narrative communicated by a firm (cf. Martin, 2016). To examine the robustness of our theorizing, therefore, we collected a 10% subsample of historical “About Us” webpages on company websites using the Way Back Machine (Internet Archive, 2020). The About Us

**Figure 1**  
**Influence of Virtue Rhetoric on Investor Reaction to Unethical Behavior: The Moderating Role of Expected Future Performance**



portion of a company website typically includes the firm’s mission and vision, information about its products and services, and related general information about the company. This information is visible and accessible, thus making it an appropriate firm narrative to compare our main findings. However, it also tends to be somewhat generic and more stable than information in the letter to shareholders, which is one reason we prefer using shareholder letters for our main analysis.

The results of this supplementary analysis in Table 5 mirror our findings using shareholder letters, providing further evidence for our arguments. As predicted in Hypothesis 1, we find a negative relationship between virtue rhetoric in About Us webpages and investor reaction to unethical behavior in Model 1 ( $\beta_{\text{Virtue Rhetoric}} = -47.74, p \leq 0.05$ ) and Model 2 ( $\beta_{\text{Virtue Rhetoric}} = -177.46, p \leq 0.01$ ). We also find support for the moderating effects of expectations of future performance on the negative relationship between virtue rhetoric in About Us webpages and investor reactions to unethical behavior ( $\beta_{\text{MTB}} = -0.97, p \leq 0.01$ ;  $\beta_{\text{Virtue Rhetoric*MTB}} = 118.76, p \leq 0.01$ ), again supporting Hypothesis 2. We again failed to find support for Hypothesis 3 ( $\beta_{\text{Financial Violation}} = -0.67, p > 0.05$ ;  $\beta_{\text{Virtue Rhetoric*Financial Violation}} = -793.35, p > 0.05$ ).

*OVO dimensions.* Our measure of virtue rhetoric is comprised of language that speaks to any of the six dimensions of organizational virtue (Chun, 2005). Some extant research examines

**Table 5**  
**The Effect of Virtue Rhetoric in “About Us” Webpages on Investor Reactions to Unethical Behavior**

| Variables                             | Model 1         | Model 2            |
|---------------------------------------|-----------------|--------------------|
| Intercept                             | 14.31 (10.61)   | 3.02 (12.20)       |
| Total employees                       | −0.41* (0.18)   | −0.33* (0.17)      |
| Total sales                           | −0.38 (0.36)    | 0.14 (0.36)        |
| Debt-to-equity                        | 0.03 (0.05)     | 0.00 (0.05)        |
| Current ratio                         | 0.41** (0.14)   | 0.44** (0.13)      |
| Return on equity                      | 0.08 (0.42)     | 0.23 (0.38)        |
| Shares outstanding                    | 2.66** (0.95)   | 1.68 (0.87)        |
| Average trading volume                | −2.48* (1.01)   | −1.77 (0.96)       |
| Analyst recommendations               | −1.06 (0.93)    | −0.21 (0.97)       |
| Institutional ownership               | −1.09 (3.36)    | 2.17 (3.47)        |
| Prior firm violations                 | 0.01 (0.01)     | 0.02 (0.01)        |
| Prior industry violations             | −0.01 (0.02)    | −0.02 (0.02)       |
| Days since last violation             | −0.00 (0.00)    | 0.00 (0.00)        |
| Media coverage                        | −0.01 (0.01)    | −0.01 (0.01)       |
| Abnormal search traffic               | −0.03 (0.03)    | −0.03 (0.02)       |
| Virtue rhetoric                       | −47.74* (27.15) | −177.46** (51.04)  |
| Market-to-book (MTB) ratio            |                 | −0.97** (0.27)     |
| Financial violation                   |                 | −0.67 (0.89)       |
| Virtue Rhetoric * MTB                 |                 | 118.76** (35.55)   |
| Virtue Rhetoric * Financial Violation |                 | −793.35 (4,140.04) |
| <i>N</i>                              | 163             | 163                |
| <i>F</i> value                        | 2.95**          | 4.32**             |

*Note:* Dummy variables for violation year, time to violation, and type of unethical behavior included in the model but not reported; *p* values for independent and moderator variables reflect one-tailed tests.

\* $p \leq 0.05$ , \*\* $p \leq 0.01$ .

each OVO dimension independently (as opposed to a single summed measure) (Payne et al., 2011). In our study, it may be that virtue rhetoric about one of the OVO dimensions has a disproportionate influence on investor reactions to unethical behavior. We classified each instance of virtue rhetoric in terms of the OVO dimension to which it relates, as shown in Table 1. Therefore, we were able to reanalyze the data using individuated measures of virtue rhetoric for each OVO dimension. We did not, however, find statistically significant relationships for virtue rhetoric aimed at any one of the OVO dimensions. This suggests there is not any one type of virtue rhetoric that is driving our findings, but rather the various types of virtue rhetoric appear to work together to produce our hypothesized results.

*Violation type.* Lastly, given that the distribution of types of unethical behavior in our sample is unbalanced, it may be that one or a few of them are more important than others and, as such, are unduly influencing our findings. We examine this possibility by reanalyzing each of the models in our main analyses using only the observations for a given type of unethical behavior. We only conducted analyses for categories of ethical violations with at least 100 observations because statistical power analysis shows that categories with fewer observations

would have insufficient power. We were unable to replicate our results in any of these subsamples, suggesting that no one type of violation is driving our results.

## Discussion

In this paper, we extend management research by examining the extent to which virtue rhetoric in investor communications helps or hurts firms that subsequently engage in unethical behavior. Business ethics has come to the forefront as a topic of interest among management scholars (Greve et al., 2010), and within this line of study, researchers have begun to consider whether and how firms communicate their ethical values (Payne et al., 2011). We ask about what happens when they do so disingenuously, insofar as they follow their ethical talk with unethical behavior. Some might suggest that using virtue rhetoric establishes that they are an ethical company, so punishments for unethical behavior could be less severe because investors will presume the behavior is a temporary abnormality. However, we find evidence in support of a counterperspective that shows high levels of virtue rhetoric in investor communications elicit strongly negative investor reactions to subsequent instances of unethical behavior. We also theorize and find that this relationship is less pronounced for firms with high expected future value.

Our study, in a variety of ways, changes the conversation in the literature about touting one's ethical values (Chun, 2017). For example, researchers have focused largely on the power of virtue rhetoric, but we use expectancy violations theory to develop arguments about a less obvious potential pitfall of communicating ethical standards. Further, extant research considers how firms can manage the message they communicate to outsiders in the wake of misconduct, but we turn attention to the message the firm has already communicated prior to the occurrence of unethical behavior. In addition, scholars have devoted considerable attention to firms that engage in bad behavior and recent scholarship investigates firms that communicate their ethical values, but we add to this literature by theorizing about the gap between what firms say and do.

The message of our study is straightforward: Top managers should diligently count the cost of engaging in virtue rhetoric in investor communications. Scholars have clearly documented the benefits of engaging in such talk (Cameron, 2003; Chun, 2017; Payne et al., 2013). We, however, draw attention to a previously obscured downside, suggesting that top managers must be careful about using virtue rhetoric disingenuously. This is because our results show that capital markets have a built-in penalty for hypocritical management. This is important because extant work on the saying-doing gap focuses more on the benefits as a means of symbolic management (Westphal & Bednar, 2008) rather than the potential costs.

Understanding how virtue rhetoric in investor communications affects investor responses to subsequent unethical conduct is compelling, in part, because the nature of the relationship is nonobvious. Some might argue that virtue rhetoric in a firm's communications with investors buffers the firm against negative investor reactions. This could occur, in part, if firms use virtue rhetoric as a form of "reputational insurance" in the hopes that a strong ethical reputation will help them deflect attributions of blame (Madsen & Rodgers, 2015). The idea is that high levels of virtue rhetoric create benevolent feelings toward the firm such that outsiders view unethical behavior as a glitch that is not likely to be a manifestation of systemic problems. Using similar logic, theory from behavioral economics suggests that individuals extend

information provided in one exchange context to others (Kahneman, 2011). Therefore, a halo effect could arise, wherein investor perceptions about the firm's ethical values, built from the company's own virtue rhetoric in investor communications, could diminish negative reactions to hearing about unethical behavior from information intermediaries. These alternative views of the phenomenon at hand would likely predict results opposite to what we found. Future research might consider scenarios in which such perspectives might be descriptive. For instance, dedicated investors with longer term investment horizons may be less sensitive to ethical violations that seemingly contradict espoused virtuosity because it might be seen as an uncharacteristic, isolated event that is unlikely to affect the company in the long run. Likewise, companies in industries mired by questionable ethical conduct, such as certain "sin" industries like tobacco, firearms, and gambling, may not experience the same level of investor backlash following unethical behavior since investors are ostensibly less concerned about ethical conduct.

There may also be some important potential insights in our finding for our second hypothesis. Studies in management and related disciplines demonstrate that investors react negatively to unethical behavior (Murphy, Shrieves, & Tibbs, 2009; Zhang & Wiersema, 2009). However, less research considers circumstances that change the way investors react to such behavior. Our results show that investors might be more tolerant when firms have high future value. These firms suffer less from unethical behavior, even if they have used virtue rhetoric to set themselves up as an ethical company. When a firm's economic outlook is good, investors seem willing to ignore bad behavior.

The lack of findings for our third hypothesis requires some retrospective consideration. Despite theorizing to the contrary, there is some evidence that investors recognize that any bad behavior by firms is incompatible with shareholder wealth maximization (e.g., Long & Rao, 1995; Skinner, 1994). This is consistent with research suggesting that heuristics regarding integrity are hierarchically restrictive (Reeder & Brewer, 1979). That is, individuals believe that an honest person will be consistently honest but that a dishonest person will potentially behave dishonestly in a wide variety of contexts (Connelly et al., 2016; Kim, Ferrin, Cooper, & Dirks, 2004). This research shows that "a single dishonest behavior is sufficient to produce a confident attribution that the actor is dishonest," and those attributions of dishonesty apply across all exchange contexts with the dishonest actor (Reeder & Brewer, 1979: 68). In our case, it could be that investors see any ethical violation as a reflection of dishonesty and thus presume that the firm and its top managers may act dishonestly in other contexts as well (e.g., with employees, customers, communities in which they operate, or toward investors). If this is the case, then the expectancy violation that underlies our first hypothesis would apply for all types of ethical violations, which may explain why the results for our third hypothesis were not consistent.

### *Implications for Practitioners*

The collective findings of our study are likely to be important to managers. Many top managers feel increasing pressure to include virtue rhetoric in investor communications to preempt ethical concerns held by investors and other stakeholders (cf. Baldassare & Campo, 2016). Almost all the firms in our sample make at least some mention of ethical values at some point in their narratives. The absence of virtue rhetoric might alarm investors and other stakeholders,

who may assume that the company does not value ethical character. Thus, at a minimum, our study shows that CEOs and top managers are, to varying degrees, using virtue rhetoric in their letters to shareholders to establish expected norms of ethical behavior.

However, our results reveal that top managers should exercise a measure of caution with their virtue rhetoric, especially if their language is more symbolic than substantive. Investor reaction to unethical behavior is *four times* as negative for firms that used high virtue rhetoric compared to those that used low virtue rhetoric. However, firms that have high future value enjoy less negative (or even neutral) investor reactions to ethical violations, and virtue rhetoric has reduced influence on investor reactions for these firms. In short, if a firm has high perceived future value, top managers can essentially disregard the risk of communicating the firm's ethical values. If perceived future value is low, top managers should only tout the firm's ethics if they genuinely believe that unethical behavior is unlikely to occur.

Following these arguments, the overarching purpose of this paper is to draw attention to a potential drawback of decoupling symbolic expressions from subsequent substantive actions. On one hand, there are benefits to espousing virtuosity in investor communications. On the other hand, we introduce the notion that there could also be concealed costs in the form of strict penalties for unethical behavior. Thus, top managers must know that, if they use extensive virtue rhetoric in communications with investors, they raise the bar of acceptable company behavior because investors will punish the firm severely if their actions do not match their words. This is important because, unlike research on trust and behavioral integrity, the drawbacks of symbolic management are not well understood (Moore, Payne, Filatotchev, & Zajac, 2019; Schnackenberg, Bundy, Coen, & Westphal, 2019).

Investors are also likely to be interested in the results of our study. Our study reveals that investors may be subject to some consequential biases, so being cognizant of those biases could help investors make good decisions (Narayanan, Zane, & Kemmerer, 2011). Foremost, it behooves investors to be aware that top managers use virtue rhetoric in their investor communications as a means of strategic framing. Moreover, virtue rhetoric in some letters to shareholders is more substantive than in others (Craig & Brennan, 2012). We found enough instances of unethical behavior among firms that had used high levels of virtue rhetoric to reveal some measure of decoupling, which shows that many top managers use virtue rhetoric as a symbolic gesture to raise external perceptions of OVO (Westphal & Zajac, 1998). In addition, investors should be aware of their own bias that they are likely to view unethical behavior differently depending on how the organization has framed themselves in prior communications. In other words, investors may be holding supposedly ethical organizations to a higher standard of ethical behavior compared to other organizations who say little about their ethical standards.

### *Limitations*

Our study has some important limitations of note. Perhaps foremost among these is that we do not directly measure the reactions of individual investors. Our study examines overall investor behavior in response to a negative organizational event (Paruchuri & Misangyi, 2015). The body of work on this topic would benefit from a complementary study that tests how specific investors respond in a controlled environment. For instance, Gangloff, Connelly, and Shook (2016) used an archival study of CAR, much like our own, to investigate how

investors respond to CEO succession following misconduct. Connelly et al. (2016) then built on this work by developing an experiment to examine the reactions of specific institutional investors to CEO succession following different types of misconduct. These two studies, one archival and one experiment, work together to provide a powerful look at CEO succession in the aftermath of misconduct. So, too, we expect an experiment in a controlled environment would allow researchers to investigate investor responses to varying levels of virtue rhetoric and different types of ethical violations in a controlled environment. Our study has the advantage of investigating what is occurring among many firms in the marketplace. An experiment, though, would go a long way toward controlling for potential confounds and confirming the causal nature of our hypothesized relationships.

Relatedly, because we are concerned with overall investor reaction, we are unable to tease out the response of specific types of investors. For example, we control for institutional investor ownership, but it could be that transient and dedicated institutional investors respond differently (Bushee, 2001). We could imagine, for example, that dedicated institutional investors might be less convinced by virtue rhetoric than transient investors because dedicated investors are intimately familiar with firms in which they invest and the top managers that run them. Similarly, transient investors might follow the lead of dedicated investors, which could create some herd behavior in response to unethical acts (Connelly, Shi, Hoskisson, & Koka, 2019). Quasi-indexers are another classification of institutional investors who, owing to their passive trading strategies, should have a dampening effect on our results. That is, if we could remove index funds from our analyses, we expect our results would be even stronger than they are now.

Our study also only focuses on investor reactions to misconduct but does not consider the potential influence of virtue rhetoric on the likelihood of misconduct. To consider this, a useful conceptual lens may be *aspirational talk theory* (Christensen et al., 2013), which describes communication that announces ideals and intentions rather than reflecting actual behaviors. Scholars working in this arena “argue that CSR communication is essentially aspirational and therefore not a perfect reflection of organizational CSR practices,” and as a result, CSR communication may “instigate organizational reality rather than describe it” (Christensen et al., 2013). This view would suggest that virtue rhetoric could be aspirational with respect to the firm’s ethical standards and thus could spur the firm on toward better behavior (Penttilä, 2020). Thus, from an aspirational talk perspective, it could be that virtue rhetoric reduces the likelihood of subsequent misconduct. This could be an important avenue of future research.

The above limitations focus on investor reactions, but that is a limitation by itself because our analysis is limited to a timeline that ends in the immediate aftermath of an ethical violation. We do not investigate what firms do in the wake of engaging in bad behavior. For example, some may manage the message better than others, and in so doing, they could mitigate the damage they incur from an ethical violation. Future research might add to our study by considering how the words that follow unethical behavior relate to the words that preceded the behavior. Such studies might incorporate key questions such as, if CEOs engage in virtue rhetoric, are they actually doing what they say? Was the ethical violation intentional, or was the CEO even aware that it was occurring? Was the CEO, who writes the letter to shareholders, the one who committed the violation? Unpacking nuances such as these offers the possibility of adding richness to the ideas put forward in our study.

Our attention in this study is limited to investor reactions, but there are many other stakeholders who may be influenced by virtue rhetoric (Payne et al., 2011). For example, benefits might come in the form of deeper levels of trust with buyers and suppliers, greater ability to hire the best talent, or improved customer retention (Anderson & Reeb, 2004; Cameron, 2003). Future studies might extend our work to consider other stakeholders on both sides of the expectancy equation. Specifically, researchers could examine various other forms of communication to gauge expectations of a range of stakeholders and consider how expectancy violations affect decision making (e.g., reduced alliances, less customers, fewer applicants). Additionally, future research should consider *who* is establishing the expectancy levels and how the communicator might influence the content and outcomes of the message; previous research has shown that top management team characteristics are linked to the espousal of OVO (Evert, Payne, Moore, & McLeod, 2018) but not whether who is sending what matters—in an interactive way—to influence investor, or other stakeholder, decisions and outcomes.

Some of our measures, too, are rough proxies for our intended constructs. For instance, we examine virtue rhetoric in letters to shareholders, but CEOs might use varying levels of virtue rhetoric in earnings conference calls with investors (Pan et al., 2018). Future research might cast a wider net to measure investor communications more broadly, including not only formal communications but also informal communications such as that which occurs in social networks (Lee, Hwang, & Chen, 2017). In addition, with respect to the different types of ethical violations, in a supplementary analysis we look at individuated violations, but this is only a partial indicator of the influence of each type of violation. Looking at each type separately considerably reduces sample size, which may explain the nonfindings. Relatedly, our measure of social media influence and information diffusion was effective but generic. Future research might leverage theory on social contagion and meme theory to examine how the rate of information diffusion affects investor responses.

While our study theorizes and finds that virtue rhetoric in investor communications is negatively related to investor reactions to unethical behavior, we cannot be certain of a causal relationship. On one hand, a number of existing studies demonstrates firm rhetoric matters to investors (e.g., Abrahamson & Amir, 1996; Chong & Druckman, 2007; Fiss & Zajac, 2006; Kohut & Segars, 1992; Patelli & Pedrini, 2014). On the other hand, virtue rhetoric may reflect something more stable and latent within a firm—that is, organizational virtuosity (Payne et al., 2013)—that influences investor reactions. Indeed, the findings in our supplementary analysis demonstrating a relationship between virtue rhetoric in “About Us” sections of firm websites and investor reactions to unethical behavior suggest the possibility that it may be more than simply rhetoric at work. Considering this possibility, future research should examine the relationship between more substantive measures of organizational virtuosity, such as investment in CSR initiatives or ethical reputation rankings, and investor reactions to unethical behavior to better understand the efficacy or inefficacy of virtue rhetoric in investor communications.

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