

Accounting Ethics: Understanding Ethical Frameworks

3rd Edition

Gordon Klein

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Course Information

Course Title: Accounting Ethics: Understanding Ethical Frameworks

Learning Objectives:

- Ascertain what occurs when people adhere to a common set of ethical standards and traditions
- Identify which group the AICPA's ethics rules apply to, as a practical matter
- Recognize which accountants are often subject to far greater pressure than others
- Choose a term which best describes ethical absolutism
- Select the Code of Conduct principle that requires that members should exercise sensitive professional and moral judgments in all their activities
- Determine the point at which moral development levels typically increase, according to a widely-accepted study of public accounting professionals
- Spot the chief advantage of utilitarianism
- Pinpoint when lying is permissible according to utilitarians
- Determine what neuroscientists using brain scans believe occur when individuals confront moral dilemmas
- Identify the philosophy which focuses on training that helps prepare a person for the eventuality of making ethically correct decisions
- Select the philosophy or theory that supports the stakeholder theory
- Spot the definition of CSR which is rejected by most commentators because it only requires mere compliance by all citizens as a minimum standard

Subject Area: Behavioral Ethics

Prerequisites: None

Program Level: Overview

Program Content: This ethics course meets the requirements for those states which require a general or behavioral ethics course. It uses a contemporary focus which immerses you in real world ethical questions. Covers topics related to: ethical principles and reasoning; core philosophies; virtue, justice, and social responsibility; and more.

Course Information

Advance Preparation: None

Recommended CPE Credit: 4 hours

Course Expiration: Based on standards set by NASBA and the AICPA, this course will expire one year from the date of purchase.

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About the Author

Gordon Klein has dedicated his professional career to accounting education and the equitable resolution of financial disputes. As a CPA, attorney, and faculty member at UCLA for over three decades, Mr. Klein has taught undergraduate, graduate, and law students courses in managerial accounting, tax planning, advanced financial accounting, fiduciary responsibilities, and professional ethics. Moreover, Mr. Klein has served as an ethics consultant to the California Bar Association, a judicial referee, and an arbitrator of accounting disputes. Mr. Klein is an international accounting expert who has testified in several highly publicized matters, including a set of mortgage-backed securities disputes that the *Financial Times* heralded as “this century’s biggest case against Wall Street.”

Mr. Klein’s commentaries have appeared in the *Wall Street Journal*, and he has been a television commentator on CNBC. He also has a passion for contemporary music and has appeared on MTV on several occasions.

Chapter 1

Introduction to Ethics

Learning Objectives

- Ascertain what occurs when people adhere to a common set of ethical standards and traditions
- Identify which group the AICPA's ethics rules apply to, as a practical matter
- Recognize which accountants are often subject to far greater pressure than others

Am I Ethical?

During college, your buddies called you *Boy Toy* because so many women dated you once and then cast you aside. You now work as an accounting manager in a manufacturer's Accounts Receivable and Payable Division, but you still lead an active dating life. Just last month, you dated three different women that you met through work. One works for a company supplier, one works for a major wholesale distributor, and the third is a subordinate who works under your direct supervision.

The head of Human Resources recently summoned you in for a meeting, and you are concerned that she intends to discuss your prolific dating habits. Is it ethical for her to discuss your private dating life?

- a. Yes, but only regarding romantic involvement with your subordinate
- b. Yes, because all three dating arrangements pose potential conflicts of interest
- c. No, because it is unethical for an employer to interfere in employee activities outside the workplace
- d. No, because you are protected by Constitutional freedoms of speech, free association, and privacy

The **solution** is revealed at the end of the chapter.

What Are Ethics?

A bus is speeding out of control in your direction. As you frantically look around, you see that a foreign tourist named Jack and your dog, Ice Cube, are in the direct path of the bus. You have time to save just one of

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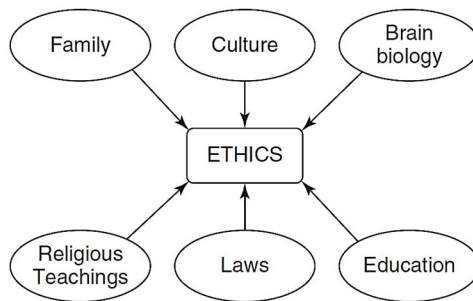
them. Should you let the bus whack Jack, or should you let Ice Cube get crushed?

According to a recent study, over 40% of people questioned would save their dog instead of the tourist. What choice would you have made?¹

Ethics guide us in identifying right from wrong, good from bad, and just from unjust. Some describe ethical behavior as the decisions you make in the dark when no one is watching. Google’s Code of Conduct has a more succinct mandate: *Don’t be evil!*

Ethical norms evolve over time and reflect a broad community consensus. Some contend that ethical values are inextricably linked with religious teachings and cannot exist in a world devoid of spiritual influences. Nobel Prize winner Albert Einstein, in contrast, believed that “there is nothing divine about morality; it is a purely human affair.”² “A man’s ethical behavior should be based effectually on sympathy, education, and social ties and needs; no religious basis is necessary.”³ From yet another vantage point, neuroscientists believe that certain ethical behaviors are *hardwired* into our brains, making these behaviors largely unsusceptible to religious or educational influences. Regardless of whether morality has divine origins, cultural underpinnings, or a biological basis, societies tend to flourish when people adhere to a common set of ethical standards and traditions.

FIGURE 1-1 Influences on Ethics



Ethics and Accounting

At first glance, the pairing of ethical philosophies with accounting is a seemingly odd coupling. After all, our great philosophers spent their time

¹ Study by Georgia Regents University and Cape Fear Community College, reported in *Anthrozoö* and cited in Huff Post “Weird News,” August 22, 2013. According to this same study, only 2% of the respondents would save the life of their dog over the life of an immediate blood relative. Perhaps that is reassuring; perhaps not.

² Albert Einstein, *The World As I See It*, trans Alan Harris (New York: Philosophical Library, 1949).

³ Albert Einstein, as quoted in *New York Times*, 11/9/30.

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contemplating moral values, not book values. Likewise, accounting experts generally are more facile at discussing corporate bonds than societal bonds. Surprisingly, though, the confluence of ethics and numerical analysis has existed for centuries.

Although Aristotle is best known for his philosophical insights, he also expressed opinions that remain tenets of modern accounting. In his discourse about the benefits of free trade, for example, Aristotle pioneered the view that goods should be valued objectively based on actual transactions, not based on subjective assessments of intrinsic worth.⁴ Aristotle's views, first expressed in 350 BC, continue to guide accounting determinations of fair market values.⁵

Descartes was also a major contributor to both philosophy and modern financial analysis. In the abstract realm of philosophy, Descartes is best known for the introspective proposition, *I think; therefore I am*. However, Descartes also was a pragmatist who, in the 17th century, invented the famed x-y axis graph that still is used today in algebra and cost accounting analysis.

Even Albert Einstein's fascination with numbers was tempered by his enduring respect for the importance of ethics. Notably, Einstein once wrote, "Not everything that counts can be counted, and not everything that can be counted counts."⁶

Ethics in Our Daily Lives

Many financial professionals dread the study of ethics, fearing that rules developed by ancient civilizations have little relevance to contemporary business decisions. Some think that the study of *ethos*, or moral character, is the narrow province of balding old men dressed in togas and medieval theologians singing Gregorian chants. The simple reality, however, is that we all must decide between right and wrong on a daily basis. Ethical issues abound everywhere, whether we are wearing a toga or dressed for yoga, and whether we are a monk or just listening to punk or funk.

Most of us are so accustomed to dealing with ethical issues that we instinctively make moral decisions without even realizing it. For example, when you awaken in the morning, your first ethical decision might be whether you should jump in the shower right away, knowing that your

⁴ Aristotle, *Politics*.

⁵ Aristotle also wrote extensively about the societal benefits of voluntary commercial transactions and exchanges in *Nicomachean Ethics: Book V*.

⁶ Ethical rules are imposed externally by an organization or by broader society, whereas moral rules are self-imposed. Although subtle differences exist between the concepts of ethics and morality, for simplicity of exposition, these terms will be used interchangeably.

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use of the available hot water might delay your roommate from getting to work on time.

You then arrive at class a bit late because you overslept. When the instructor stares at you disapprovingly, you mutter that “traffic was horrible,” even though it was not.

At lunch, you notice a college administrator stating that she is a student to get a discount on a food purchase. You wonder whether you should inform the cashier, but you choose to avoid conflict with the administrator.

Between classes, you ask your professor for “special tips” on how to do better on an upcoming midterm, knowing that your course grade is curved relative to your classmates’ performance.

At your part-time afternoon job, after using a company pen to jot some notes, you place the pen in your pocket to take it home. You also use the company computer to transact an online purchase of sunglasses while waiting for your boss to return with your work assignment.

On your way home, you stop in a shoe store to figure out which size shoe fits you best. You thank the salesperson for his diligent help, but then order these shoes online to save money.

While driving home from the shoe store, you notice that a car accident in the far right lane is forcing several cars to slide over into your faster-moving lane. You allow only two cars to merge into your lane, even though other drivers are signaling their desire to merge.

After arriving at your apartment, you feel somewhat tired. As a result, you back out on your friends, claiming that you “have too much homework” to go out that evening, although you had previously agreed to join them. Because your friends lack convenient access to transportation, your change of heart disrupts their plans.

That evening, you are struggling to understand a difficult financial concept, so you call an acquaintance from your accounting class. You know that he will patiently share his time because you suspect he has a romantic crush on you. You need his academic assistance, but you dread the prospect of him asking you out on a date.

Immediately after your chat, you go to an online dating website to post your photo, which was shot at a wedding three years ago. You also reply to an email from your work supervisor and agree to meet him Saturday evening at a club with live music. You plan to bring your fake ID in case you want to order an alcoholic drink. You really enjoy that club because the cover band plays recent hit songs and has an awesome lead singer. You enjoy this band so much that you recorded a few of its songs onto your mobile device.

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Finally, you are disappointed that the college counselor did not answer an email that you had sent earlier that morning. Before going to bed, you impatiently re-send that email.

Which of these issues involve ethical decisions? You don't need the genius of Socrates or Saint Thomas Aquinas to answer this question . . . they all do!

Example 1-1

Upon arriving by car to deliver medicine to a sick friend, you are frustrated that all the nearby metered parking spaces are filled. You notice that the parking lot of a nearby supermarket is only about half-filled and do not see any *Customer Parking Only* signs posted. Your friend urgently needs to ingest this medicine. Is it ethical for you to park in the supermarket's lot?

Solution

From one philosophical viewpoint, your unauthorized use of the supermarket's parking space was an unethical theft of another's property rights.

Other ethical philosophies, in contrast, consider actions to be ethical if the resulting societal gains exceed the costs. From this cost-benefit perspective, your use of the parking space was ethical because it allowed you to expeditiously help your friend without materially harming the supermarket or its customers.

The various ethical philosophies used in evaluating decisions will be explored more fully in subsequent chapters.

Ethics in Our Professional Endeavors

Honorable accountants reasonably may differ about the correct ethical path to follow in certain situations. As a result, various organizations have developed rules that guide accountants in fulfilling their professional responsibilities. The two most comprehensive and commonly utilized codes of conduct are the *AICPA Code of Professional Conduct* and the *IFAC Code of Ethics for Professional Accountants*.

The AICPA Code of Professional Conduct

The American Institute of Certified Public Accountants, or *AICPA*, has developed rules of conduct that govern accountants practicing in the United States. These rules, known as the **AICPA Code of Professional Conduct**, have been in force for several decades and were revised in 2014. These rules apply to all CPAs, whether they work in private practice, industry, government, academia, or other capacities.⁷

⁷ <http://www.aicpa.org>.

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The AICPA is a national professional organization comprised of approximately 400,000 CPAs.⁸ From a narrow perspective, the AICPA's rules only govern the conduct of members who voluntarily join this organization. However, every state has an official Board of Accountancy that, by law, regulates all CPAs licensed and practicing in it. In most instances, state legislatures and state governmental boards have adopted the AICPA's ethical framework as mandatory legal requirements. For example, California's accountancy laws require all CPAs to "comply with all applicable professional standards," including the AICPA's ethics rules.⁹ Consequently, as a practical matter, most AICPA rules have the force of law behind them and subject violators to having their professional licenses suspended or revoked. Furthermore, in disciplining non-CPAs, judges, juries, and regulators often refer to the AICPA's rules as persuasive expressions of how financial professionals should behave. Accordingly, the AICPA's rules, as a practical matter, broadly establish the governing standard of conduct for all accountants and financial professionals practicing in the United States.¹⁰ For this reason, throughout this book, we will assume that the AICPA's rules are the relevant benchmark of behavior for all accountants and financial professionals, whether or not they formally are CPAs or members of the AICPA.¹¹

⁸ Certified Public Accountants perform a variety of tasks. CPAs alone are permitted to perform audits and other tasks that involve attesting to the fair presentation of financial statements. Also, only CPAs, along with attorneys and certain other professionals, may represent taxpayers in dealings with the IRS. To become licensed as a CPA, an accountant must pass a standardized test called the Uniform CPA Exam. In addition, CPA candidates must satisfy specific rules established by the state in which they practice. All states require a CPA candidate to, at minimum, possess a college degree and have successfully completed substantial coursework in accounting analysis and ethics. Most states also require CPA candidates to serve an apprenticeship under the supervision of another CPA.

⁹ California Board of Accountancy, Article 9, Section 58.

¹⁰ The AICPA Code also applies to members practicing outside the United States if a financial statement reader would reasonably believe that U.S. professional practices were followed.

¹¹ These rules are supplemented by various others, including mandates established by the Public Company Accounting Oversight Board and related securities laws. Also, in the United States, other voluntary accounting organizations have also established ethical rules for their members. The Institute of Management Accountants, the Institute of Internal Auditors, the National Association of Enrolled Agents, and the Association of Government Accountants, to name a few, have all developed rules of professional conduct. The ethics rules of these organizations substantially resemble those established by the AICPA, but they generally are less detailed.

FIGURE 1-2 Principal Sources of Ethics Rules for Accountants

Mandated By:	In United States	Outside United States
Private Organizations	American Institute of CPAs (AICPA)	International Federation of Accountants (IFAC)
Government Body	Tax Practice: <i>US Treasury and IRS</i> Financial Reporting by Publicly Traded Corporations: <i>SEC (which approves rules of the Public Company Accounting Oversight Board)</i>	<i>Varies among jurisdictions</i>

The IFAC Code of Ethics for Professional Accountants

For accountants practicing or issuing financial statement opinions for users outside the United States, the International Federation of Accountants, or *IFAC*, has established a set of ethical standards. The IFAC created the International Ethics Standards Board for Accountants to “develop and issue, under its own authority, high quality ethical standards and other pronouncements for professional accountants for use around the world.” For brevity, these rules shall be referred to as the **IFAC Code**.¹²

The IFAC is an “organization of organizations,” whose members are professional societies rather than individuals. The IFAC principally is comprised of about 160 accounting societies, ranging from the Albania Institute of Authorized Chartered Auditors to the Zimbabwe Institute of Chartered Accountants. The AICPA also is a member. IFAC’s member organizations collectively represent 2.5 million accountants who work in industry, government, public practice, and academia.

IFAC group members are not permitted to establish standards that are less stringent than those that are expressed in the IFAC Code. Therefore, because the AICPA is a member of the IFAC, the AICPA Code necessarily is at least as strict as the IFAC Code.

As a pragmatic matter, the rules established by both such codes are substantially similar. As a result, the core principles embodied by both the IFAC and AICPA codes will collectively be referred to hereafter as the **Code of Conduct**.¹³

¹² The formal name of this code is the IESBA Code of Ethics for Professional Accountants.

¹³ When significant differences exist between the AICPA and IFAC Codes, they will be identified.

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Example 1-2

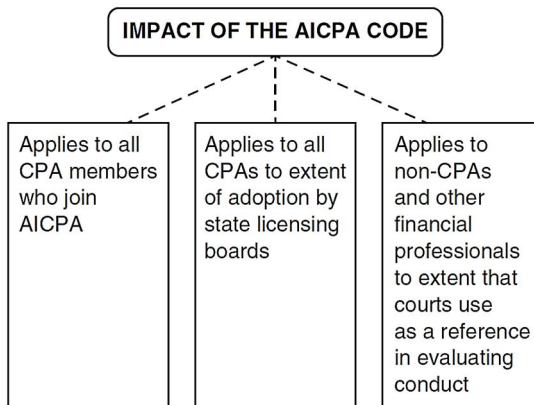
The IFAC Code and the AICPA Code both impose restrictions on an accountant receiving free tickets to a sports event from a client. The IFAC Code generally applies these restrictions only to members of an audit team and to a limited number of others who influence an audit engagement.

If the AICPA wishes to apply its ethics rules to a broader set of individuals than the IFAC Code encompasses, may it do so?

Solution

Yes. As a member of IFAC, the AICPA may establish rules that equal or exceed IFAC standards. It may not, however, impose less-restrictive standards.

FIGURE 1-3 Impact of the AICPA Code



Other Sources of Accountant Regulation

In the United States, several federal government agencies also regulate accountant conduct. The U.S. Treasury and Internal Revenue Service (IRS) govern the conduct of tax professionals, and the SEC and the Public Company Accounting Oversight Board regulate financial reporting by publicly traded companies. In addition, many states have adopted rules regulating the practice of accounting. These rules are patterned after the *Uniform Accountancy Act*.

For the most part, government regulators have deferred to the AICPA in the area of ethics standard-setting because all such organizations share the same core goals.¹⁴

¹⁴ The ethical rules of the accounting profession should be distinguished from the substantive reporting standards. Financial reporting standards are referred to collectively as *generally accepted accounting principles*, or *GAAP*, whereas the standards for planning and conducting an audit are referred to as *generally accepted auditing standards*, or *GAAS*. In the United States, the authoritative

Ethical Judgments in Accounting

Ethics in Financial Accounting

People unfamiliar with financial reporting easily might wonder how an accountant would ever encounter an ethical dilemma. After all, debit and credit entries can be accomplished by automated processes, free of human involvement.

However, accounting is more than just the bookkeeping process of recording and compiling data into financial statements. Many areas of accounting require significant professional judgment.

Consider the dilemma that arises if your employer, a restaurant, is expected to lose \$1 million in a lawsuit because an angry customer was injured from consuming the chef's experimental new pizza seasoning, which was a flavorful blend of savory herbs and rat poison. According to generally accepted accounting principles, you must accrue an immediate liability if this loss is probable. But what exactly does *probable* mean?

If your employer applies International Financial Reporting Standards, *probable* means that it is more likely than not that a company will sacrifice cash or other resources in the future. *More likely than not* signifies that the odds of a loss are above 50%.¹⁵ This mathematical statement is clear, but its application is not. How can an accountant make this probability judgment when even an experienced litigator would hesitate to forecast the outcome of a trial before it has begun? Nonetheless, accountants have an ethical obligation to use their best efforts in making this subjective determination.

Conversely, under U.S. accounting rules, rule-makers similarly mandate that *probable* losses must be recorded, but they have not provided concrete numerical guidance for determining when a loss is sufficiently likely to meet this vague test. As a result, accountants have broad discretion in interpreting the word *probable* and an ethical obligation to valiantly try to fairly present a company's financial position.

Adding to your ethical dilemma in pondering the meaning of *probable*, you are likely to encounter various workplace pressures. For instance, your employer may pressure you to delay reporting a loss before

reporting standards that comprise GAAP are issued by the Financial Accounting Standards Board, or *FASB*, and are contained in the Accounting Standards Codification. Outside the United States, the authoritative reporting standards are referred to as International Financial Reporting Standards, or *IFRS*, and are issued by the International Accounting Standards Board, or *IASB*. Auditing standards broadly are dictated by three different sets of rules. The AICPA's Auditing Standards Board establishes the standards for audits of nonpublic companies in the United States, the Public Company Accounting Oversight Board establishes the counterpart standards for audits of public companies in the United States, and IFAC's International Auditing and Assurance Standards Board provides the framework for audits of companies outside the United States.

¹⁵ International Accounting Standard 37.

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it even has had the opportunity to defend itself in court. However, lenders and investors may push you to accrue the loss immediately so they can make timely judgments in protecting their financial interests in a restaurant that might be bankrupted by a large litigation loss.

As this illustration demonstrates, when faced with uncertain standards and conflicting peer pressures, even a highly conscientious accountant may struggle to reach an ethically correct decision.

Ethics in Tax Reporting

According to the IRS, tax evasion cost the federal government over \$3 trillion in uncollected taxes over the past decade. Cheating on taxes is so widespread that pundit Will Rogers once commented, “The income tax has made liars out of more Americans than golf has.”

As a tax accountant, you inevitably will encounter clients who concoct questionable schemes, claim dubious deductions, or simply lie. If you resist their requests for aggressive tax reporting, these clients sometimes threaten to shift their business to someone more “open-minded.” Thus, accountants often encounter the ethical dilemma of maintaining lucrative client relationships while continuing to uphold the integrity of our tax system.

Specific ethical rules governing tax practice appear in the AICPA’s Statement of Standards in Tax Practice and U.S. Treasury Circular 230.¹⁶

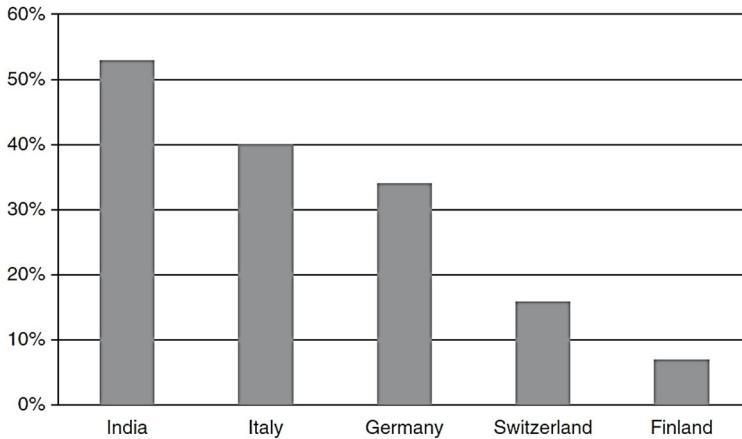
Ethics in Internal Controls

Internal auditors play a crucial role in ensuring that organizational results are reported fairly and regulatory mandates are meticulously satisfied. At times, an internal auditor’s duty to report suspected fraud, bribery, and other illegal activities may pose a severe test of integrity. Nonetheless, internal auditors must perform their duties with the highest degree of professionalism, even if their conclusions potentially devastate the careers of colleagues they interact with on a daily basis.¹⁷

¹⁶ Individuals working in the tax compliance and advisory field may wish to demonstrate their proficiency by becoming an Enrolled Agent. Enrolled Agents must pass a rigorous exam administered by the IRS. Unlike the CPA exam, the EA exam only focuses on tax accounting issues. One benefit of becoming an EA is that the IRS permits Enrolled Agents, along with CPAs, actuaries, and attorneys, to represent clients in disputes with the IRS.

¹⁷ Accountants working in internal auditing often become Certified Internal Auditors and join the Institute of Internal Auditors, which has its own ethics code.

FIGURE 1-4 The Percentage of Executives Who Believe That Companies in These Countries Often Exaggerate Their Reported Financial Performance¹⁸



Ethics in Management Accounting

Accountants who work for business entities are the frontline soldiers in the ethical battle to present accurate financial statements. As the first paragraph of a standard auditor’s report succinctly states, “These financial statements are the responsibility of the Company’s management.”

Although all accountants encounter ethical conflicts, accountants working in industry often are subject to far greater pressure than others are. Accountants working in a CPA firm never want to lose a client, but the loss of one client rarely poses a major threat to their standard of living. In contrast, a management accountant’s entire livelihood often depends on maintaining the approval of a direct supervisor or employer. For this reason, management accountants have to be acutely aware of their ethical obligations and rights, including the protections granted by government regulations, whistleblower statutes, and company policies.¹⁹

¹⁸ Ernst and Young Global Fraud Survey, 2013; results from a global survey of over 3,000 corporate directors, managers, and their team members.

¹⁹ New York Times, “U.N.C. Investigation Reveals Athletes Took Fake Classes.” By Sarah Lyall October 22, 2014.

FIGURE 1-5

Unsportsmanlike Conduct²⁰

Imagine discovering the following course description: “Class has no lectures, tests, or attendance. If you need a guaranteed high grade to pad your academic standing, take this class!”

For nearly two decades, Jan Boxill, a University of North Carolina faculty member and academic adviser, happily directed over 3,000 athletes into bogus classes fitting this fictionalized description. She did it for one simple reason—to make sure that all athletes satisfied NCAA grade point requirements to remain eligible to play.

As for Boxill, ironies abound. Before her 2015 firing from the university’s philosophy department, she directed its Center for Ethics and taught a course called *Ethics in Sports*. Yet, she unhesitatingly exploited students for their athletic talent while cheating them out of meaningful educational opportunities. She also intervened with other professors to get failing athletes passing grades, ultimately bringing great shame to the athletic programs that she held dear.

In the parlance of football, some might say that Boxill engaged in illegal Pass interference.

Ethics in Governmental and Nonprofit Accounting

In 1819, Supreme Court Chief Justice John Marshall issued his famed dictum that “the power to tax involves the power to destroy.” Whether you pursue a career in taxpayer compliance or other areas of government service, you must always remain mindful of the government’s vast power and your ethical duty to act with restraint.

The dangers of unchecked government power recently came to the forefront when the IRS wrongfully denied tax-exempt status to certain nonprofit organizations based on their political agendas. As a result of this interference, the IRS selectively impeded certain citizens from organizing to exercise their freedom of political expression. The IRS’s efforts were especially pernicious because many of the affected groups favored a simplified tax system that challenged the power and size of the IRS.

²⁰ Accountants working in industry often pursue a designation as a Chartered Management Accountant. To become a CMA, a person must work in managerial accounting and pass a rigorous exam administered by the Institute of Management Accountants. Like the AICPA, the IMA has established a code of professional ethics. The designation of Chartered Global Management Accountant, or CGMA, is relatively new and rapidly is gaining prominence. It too has its own ethics code, which is patterned after the IFAC Code.

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Although many government accountants specialize in tax matters, numerous other career opportunities exist for accountants at the federal, state, and local levels of government. At the federal level, accountants serve in a wide array of capacities in organizations such as the FBI, the General Accountability Office, the Defense Contract Audit Agency, and the IRS’s Criminal Investigation Division. Accounting careers in state government often involve the administration of state income and sales tax revenues, and careers in local government commonly involve property tax administration, budgeting, and general financial management.²¹

Ethics in Other Accounting Roles

Accountants perform many functions, including acting as personal financial planners, investment managers, trustees, estate executors, management consultants, and corporate directors and officers. In many of these capacities, clients entrust significant portions of their wealth to their accountant and become wholly dependent on the accountant’s advice and decision making. For example, if an accountant is appointed to oversee a trust fund for young children, the children’s future financial security rests on the accountant acting prudently. When accountants hold a special position of trust over vulnerable clients, they are expected to satisfy an elevated duty of care and loyalty. This obligation is called a *fiduciary duty*.

Accountants serving in these capacities should be mindful of the AICPA’s Statement on Standards for Consulting Services, Statement on Standards for Valuation Services, and Statement on Standards in Personal Financial Planning Services.

Common Ethical Rationalizations

During childhood, we instinctively learned to rationalize our misconduct. No matter how improbable our excuses were, we steadfastly tried to deflect blame by swearing that the “dog ate it” or saying something equally ridiculous. The fear of parental disapproval and punishment inspired us to conjure up some remarkable, albeit improbable, tales that would have made Pinocchio proud.

As we became adults, however, we soon realized that greater sophistry was needed to persuade others to accept, or at least indulge as plausible, our excuses for misbehavior. Let’s consider some of the most common ethical rationalizations.

²¹The best-known organization of accountants working in the public sector is the Association of Government Accountants. It has its own ethics code.

“Everyone Does It”

Cyclist Lance Armstrong seemingly had it all. He had won a record seven consecutive Tour de France victories, overcoming remarkable odds as well as a bout with cancer. He was also one of the most celebrated and financially successful athletes in the world. Then, as evidence against him mounted, he was forced to reveal that he was a *doper*—someone who had used illegal performance enhancers to cheat his way to the top.

Perhaps more shocking than Armstrong’s admission was his defense: Everyone does it. Rather than set a moral tone for others to follow, the unrepentant Armstrong shrugged off criticism, claiming that he was compelled to cheat to create “a level playing field.” Armstrong’s own financial playing field has been decimated by lawsuits claiming that he defrauded sponsors into hiring him as their advertising spokesperson. In 2015, Armstrong was ordered to pay \$10 million as damages to a sports promotion firm, and the road ahead is filled with treacherous litigation potholes and financial punctures.

Contrary to Armstrong’s perspective, no one is forced to cheat, and everyone does *not* do it. Just look at how people behave the next time that a traffic light malfunctions at a busy intersection. Most drivers behave courteously and proceed through the intersection in an orderly, alternating sequence. Chaos could easily occur, but it rarely does because most people share a common desire to act cooperatively and selflessly.

“The Other Guy’s Worse”

This justification is simply a variation of the *everyone does it* rationalization. Many people attempt to deflect blame from their own conduct by pointing out that someone else’s conduct is worse. In a world of mass murderers and billion-dollar fraudsters, there will always be someone whose conduct is worse than your own. Even if others misbehave egregiously, their conduct does not absolve you from responsibility for your own actions.

“If It’s Not Illegal, It Can’t Be Wrong”

Our legal system establishes minimum standards of behavior, not ideal standards. Petty crimes and well-concealed crimes often slip through the proverbial net of justice, but that does not make these acts ethical.

Imagine that a work colleague or classmate is severely allergic to peanuts. Would you bring peanuts near this person, just because doing so is not illegal? Just because our legal system does not circumscribe certain behavior or is ill-equipped to prosecute it, allow your *moral GPS* to guide you to act considerately.

“No Harm, No Foul”

If misconduct did not cause any harm in hindsight, wrongdoers often contend that it is pointless to examine the propriety of their conduct.

This type of logic confuses the after-the-fact, or *ex post*, outcome with the risk-creating act that occurred. Even if, by fortuity, an unethical act does not result in harm, the immorality of the initial act does not change its character.

Consider the plight of a thief who shoots a gun at a security guard at close range during a bank robbery, but misses due to bad aim. Should the robber be rewarded for his incompetence? Or should his intent to kill be severely punished, whether or not he fortuitously was an inept marksman?

In our legal system, this robber does benefit because attempted, but unsuccessful, homicide generally is punished less severely than successful homicide. However, from an ethical standpoint, the robber’s lack of marksmanship skill does not change the immorality of his actions, and it should not alter how society judges his conduct.

“They Made Me Do It”

When we make a mistake, it is human nature to blame someone else rather than accept the consequences of our actions. Despite the pressures that arise in a workplace setting, it is unethical to shirk responsibility for your actions by blaming others.

As one example, in tax fraud prosecutions, desperate taxpayers often try to portray themselves as innocent victims who were harmed by the carelessness of an incompetent assistant, bookkeeper, or tax return preparer. Shifting blame rarely succeeds in tax prosecutions. More important, it rarely succeeds in life.

Ethics in This Book

Many ethicists study **normative ethics**, which focuses on how people *should* behave. As business professionals, it is equally important to examine **behavioral ethics**, which examines how people *in fact* behave. This book will examine both ethical approaches to enable readers to better themselves by comparing their own conduct to ideal standards.

Why Should I Be Ethical?

Accountants, as pragmatic professionals, are entitled to ask, “Why should I be ethical?”

Chapter 1 – Introduction to Ethics

For one reason, everyone’s quality of life depends on widespread adherence to ethical standards because a society that is devoid of ethicality cannot provide adequately for public safety, welfare, and commerce. In societies where stealing is rampant and personal safety is at risk, people lose their privacy and live in a constant state of fear. Similarly, in societies where others cannot be trusted to honor contractual promises, commerce becomes impaired, inevitably causing economic prosperity to suffer. As a Justin Timberlake song reminds us, “what goes around . . . comes way back around.”²²

In the context of professional ethics, there are compelling, straightforward reasons to act ethically. When financial practitioners violate professional standards, clients, employers, and others who are harmed can successfully hold them legally accountable for monetary damages. Furthermore, in many jurisdictions, adverse court judgments automatically are reported to regulators, who may revoke licenses that permit professionals to earn their livelihood. These court judgments also might make it prohibitively expensive to obtain malpractice insurance. Moreover, even if a professional license or professional society membership merely is suspended for a few months, the reputational impact resides on the Internet forever.

Finally, perhaps the simplest reason for being ethical is this: It feels good—sometimes really, really good. Neuroscientists know this because the same brain pleasure centers that excitedly react when we receive a birthday present, see a beautiful face, or eat a slice of chocolate cake similarly *light up* when we act ethically.²³ But you don’t need fancy laboratory results to tell you this because we commonly observe the joy from acting ethically in daily life. Ask people if they are more ethical than their peers, and most inevitably answer *yes*, apparently because the self-perception of ethicality feels good.²⁴ Also, observe what happens at a sporting event when a referee has the integrity to correct a mistaken judgment call against your favorite team. When your team’s points are put back on the scoreboard, complete strangers often high five one another out of shared exuberance in seeing fairness and ethicality prevail.

In short, the next time that you assist a stranger in need, return a lost earring, help a charitable cause, or simply forgo an easy opportunity to cheat, revel in knowing that your ethical conduct will bring a healthy

²² Justin Timberlake, “What Goes Around.”

²³ Greene, “Beyond Point-and-Shoot Morality: Why Cognitive (Neuro) Science Matters for Ethics.”

²⁴ Over 80% of people say that they are more ethical than their peers, despite the mathematical impossibility of their self-perceptions being true. Ann E. Tenbrunsel, Kristina A. Diekmann, Kimberly A. Wade-Benzoni, and Max H. Bazerman, “The Ethical Mirage: A Temporal Explanation as to Why We Aren’t as Ethical as We Think We Are” (Cambridge, MA: Harvard Business School, 2009).

rush of pleasure to you as well. Plus, your actions assuredly will be a lot less fattening than eating chocolate cake.

Solution to “Am I Ethical?”²⁵

[B]

Business owners have an ethical right to inquire into any activity that might directly result in harm to their property. When a superior dates a subordinate, the employer has a justifiable concern that this romantic entanglement could result in the subordinate making accusations of sexual harassment. Also, employee morale might suffer if others perceive that the subordinate is receiving preferential treatment.

When a person dates a supplier representative, a conflict of interest arises. For example, if a company is short of cash, an accounting manager may have to prioritize payments in a manner that optimizes the company’s best interest. As a result, an employer understandably might become concerned that you would give priority treatment to the supplier representative you are dating, even if that is not in the company’s best interest. Similarly, if you are dating a customer’s representative and that customer does not pay on time, you might have to decide whether to recommend cutting off shipment to them or recommend filing a lawsuit against them. Again, your employer rightfully would be concerned that you might make decisions that sacrifice the company’s best interests to preserve your dating relationship.

Freedom of speech, association, and privacy are all important ethical values. However, they do not override an accountant’s duty to be free of conflicts of interest or an employer’s right to inquire about matters that might create such conflicts.

²⁵ Throughout this book, the solutions to the “Am I Ethical?” dilemmas will be based on express rules in the AICPA and IFAC Codes of Conduct, as well as in enacted laws. When these sources of ethical guidance are silent on a matter, solutions will be based on ethical precepts that are widely accepted in Western culture, such as the rights to privacy, free speech, and free association, the protection of property rights, and freedom of contract.

Review Questions

1. Who are the frontline soldiers in the ethical battle to present accurate financial statements?
 - A. Internal auditors
 - B. Company accountants
 - C. CPA firm accountants
 - D. Tax accountants

2. What is perhaps the simplest reason for being ethical?
 - A. To prevent being held accountable for monetary damages
 - B. To preserve quality of life
 - C. Potential reputational impact
 - D. It feels good

Review Answers

1.
 - A. Incorrect. Internal auditors are not the frontline soldiers in the battle to present accurate financial statements. Internal auditors play a crucial role in ensuring that a company's results are reported fairly.
 - B. **Correct.** Accountants who work for business entities are the frontline soldiers in the ethical battle to present accurate financial statements.
 - C. Incorrect. Accountants working in CPA firms are not the frontline soldiers in the battle to present accurate financial statements. CPA firm clients rely heavily on their accountant's advice and review capabilities.
 - D. Incorrect. Tax accountants are not the frontline soldiers in the battle to present accurate financial statements. Tax accountants often encounter the ethical dilemma of maintaining lucrative client relationships while continuing to uphold the integrity of the tax system.

2.
 - A. Incorrect. The simplest reason for being ethical is not to prevent being held accountable for monetary damages. When financial practitioners violate professional standards, those that have been harmed, such as clients and employers, can hold them legally accountable.
 - B. Incorrect. Preserving quality of life is not perhaps the simplest reason for being ethical. Everyone's quality of life depends on widespread adherence to ethical standards.
 - C. Incorrect. The simplest reason for being ethical is not the potential reputational impact. If a financial practitioner's license or society membership is suspended or revoked, the reputational impact resides on the Internet forever.
 - D. **Correct.** Perhaps the simplest reason for being ethical is that it feels good.

Chapter 1 – Introduction to Ethics

Chapter 2

Ethical Principles and Reasoning

Learning Objectives

- Choose a term which best describes ethical absolutism
- Select the Code of Conduct principle that requires members to exercise sensitive professional and moral judgments in all their activities
- Determine the point at which moral development levels typically increase, according to a widely-accepted study of public accounting professionals

Am I Ethical?

As the owner of several nearby apartment buildings, you have become concerned about gun violence in your neighborhood. Out of concern for your tenants, you recently informed them that you will not renew their leases if they own or possess a gun. You clearly stated that your policy will be enforced “without any exceptions.”

Several tenants have complained vigorously. One tenant is an avid hunter who claims that your policy violates his Constitutional rights. Another tenant is a policeman who, as a condition of employment, is required to have access to a gun at all times. A third tenant is a woman who is afraid of her abusive ex-boyfriend.

Is your policy ethical?

- a. No, because the Constitution protects the private right of gun ownership
- b. No, regarding the tenant who justifiably needs protection from her ex-boyfriend
- c. Yes, as long as the policy is modified to permit the policeman to retain his gun
- d. Yes, under all circumstances

The **solution** is revealed at the end of the chapter.

Distinguishing Ethical Behavior from Legal Behavior

For thousands of years, philosophers have debated whether it is more important to have an ethical society or a law-abiding society. In 500 BC, Confucius expressed the widely-accepted view that “the best government

Chapter 2 – Ethical Principles and Reasoning

is one that rules through rites and the people’s natural morality, rather than by using . . . coercion.”

Laws represent society’s consensus about how citizens must, at minimum, behave. In contrast, ethical precepts focus on how people *should* behave. Although these two concepts often overlap, there can be stark differences between complying with the law and adhering to what is morally right.

It is not illegal to cheat on a college test, for instance, but it certainly is unethical. Conversely, it is illegal to drive above the posted speed limit, but it is not unethical if you are driving a bleeding neighbor to the hospital.

When people fail to adhere to laws, they are subject to criminal sanctions such as imprisonment. Ethics, on the other hand, is prescriptive for how we ought to behave, not coercive. Thus, the punishment for unethical behavior is a heaviness of heart and a conflicted conscience.

The interplay of law and ethics can be illustrated by the plight of movie stars Halle Berry and Jennifer Garner. These actresses repeatedly have decried the conduct of paparazzi who frighten their children by popping out of bushes to photograph the children near school. To these actresses’ dismay, Constitutional protections for the freedom of the press make it impossible for our legal system to fully protect these children. However, moral outrage and societal pressure have filled this void, successfully persuading these intrusive photographers to respect children’s privacy. As former Supreme Court Justice Potter Stewart once opined, “Ethics is knowing the difference between what you have a right to do and what is right to do.”

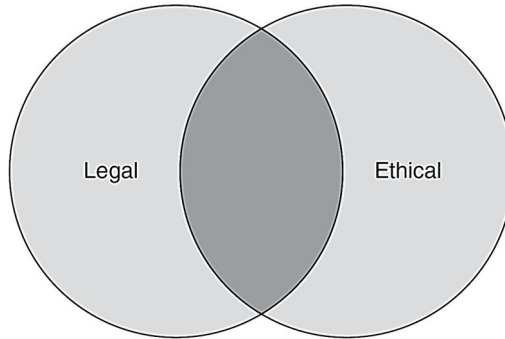
Example 2-1

According to state law, a restaurant owner is required to give employees a 20-minute work break every four hours. However, at a popular restaurant, food servers do not want to take an evening break because they generate substantial tips from satisfied customers during the hectic, but profitable, dinner period. Is it ethical for a restaurant manager to allow food servers to voluntarily forgo their work breaks?

Solution

Yes. The restaurant’s actions are illegal, but ethical. Although this law is well intentioned, food servers and employers ought to be allowed to pursue their mutual self-interests.

FIGURE 2-1 How Law and Ethics Intersect



The Universality of Ethical Rules

Do all countries and cultures agree on the same ethical principles? Or, do ethical precepts vary among societies and evolve over time? These two opposing views are known as *ethical absolutism* and *ethical relativism*.

Ethical Absolutism

According to **ethical absolutism**, ethical rules are universal and immutable. As one indicator of global consensus, the United Nations adopted *The Universal Declaration of Human Rights* to recognize a “common understanding” of the “inherent dignity . . . of all members of the human family.” This declaration embraces universal respect for thirty “human rights and fundamental freedoms,” including broad rights to equality, justice, and freedom of expression, as well as more specific rights, such as equal pay for equal work, parental control of their children’s education, and protection against unemployment. This declaration was enacted in 1948 without a single dissenting vote, and it has remained intact ever since.¹

Moreover, as further evidence of ethical absolutism, supporters point out that the Golden Rule of “Do unto others as you would have others do unto you” has been firmly entrenched in all major world religions and societies for many centuries.

Ethical Relativism

Ethical relativism, in contrast, asserts that rules of morality evolve over time and vary among cultures, religions, and political structures. Several

¹ Eight nations, however, did abstain from the vote.

Chapter 2 – Ethical Principles and Reasoning

illustrations demonstrate the variations in ethical viewpoints among cultural groups.

The Issue of Gay Rights

Stark differences persist around the world about whether gay rights are a moral imperative. In many Western societies, the notion of equal rights for all, regardless of sexual preference, increasingly is embraced. In contrast, prior to the 2014 Winter Olympics, Russia provocatively enacted laws authorizing the arrest of gay tourists.² Uganda recently went even further, imposing jail sentences on clergymen who conduct gay marriage ceremonies and life imprisonment on those who engage in homosexual acts.³

The Issue of Gender Equality

Views on gender equality also vary widely among cultures. Many Americans reflexively disparage countries that permit gender-based discrimination, but few realize that widespread support for gender equality is a relatively recent phenomenon in their own country. For example, American women were not guaranteed the Constitutional right to vote until 1920,⁴ and until the mid-1800s, married women desiring to retain control of their wealth nonetheless were generally compelled to transfer their personal earnings and assets to their husbands.⁵

The Issue of Freedom of Contract

Freedom of contract and the enforceability of agreements generally are regarded as important values in most societies because commerce enables economies to flourish. However, many countries view certain kinds of contracts as violating widely held notions of morality. Consider, for instance, how various societies view contracts for the sale of human organs. Some countries condemn the commercial trade in organs as violations of human dignity that inevitably exploit the poor. Others, however, espouse the contrary view that society benefits when individuals in need of cash are permitted to voluntarily sell their organs to buyers in failing health.

² <http://www.nytimes.com/2013/07/28/opinion/sunday/mr-putins-war-on-gays>.

³ http://www.washingtonpost.com/world/ugandan-anti-gay-bill-includes-life-imprisonment-for-certain-acts/2013/12/20/ce2e6b88-6995-11e3-ae56-22de072140a2_story.html.

⁴ Some countries in Western Europe did not grant women the right to vote until much later, with Switzerland first allowing women the guaranteed right to vote in 1974.

⁵ B. Zorina Khan, *The Democratization of Invention: Patents and Copyrights in American Economic Development, 1790–1920* (New York: Cambridge University Press, 2005), pp. 163, 166–8.

Chapter 2 – Ethical Principles and Reasoning

Reaching a consensus about the proper balance between saving lives and preserving the sanctity of one's own body has remained elusive. China, India, and the Philippines, for instance, once allowed the sale of human organs, but later enacted legal prohibitions in response to changing societal views. Iran, normally not considered a paradigm of personal freedom, presently is the only country that permits its citizens to openly sell their organs.

The Issue of Charging Interest

As a final illustration, cultures differ widely on whether lenders should be allowed to charge interest on loans. Centuries ago, Aristotle generally was a strong proponent of free market transactions, but he abhorred the concept of interest and those who charged interest. As Aristotle once wrote, “Money was intended to be used in exchange but not to increase at interest . . . the birth of money from money . . . is most unnatural.” Aristotle also believed that lenders who had “a sordid love of gain” were outcasts who should be ostracized along with “those who ply sordid trades [and] pimps”⁶

Shakespeare likewise expressed the distaste of many in Elizabethan England for the tactics used by lenders to recover interest. In the Shakespearean play *Merchant of Venice*, for example, lender Shylock reminds a borrower that, if he defaults in repaying amounts due, Shylock will repossess a “pound of [his] fair flesh, to be cut off and taken in what part of your body pleaseth me.”

The morality of charging interest remains controversial, even in modern times. Many Western societies condemn lenders who charge excessively high interest rates and have enacted *usury* laws to deter such conduct. Elsewhere, Islamic countries apply the moral principle of *riba*, which prohibits the payment of interest altogether. In accordance with Islamic accounting principles, for example, a sale is void if the amount that a seller will collect on deferred payments increases or accrues over time.⁷

⁶ Aristotle (Author), R. F. Stalley (Editor), Ernest Barker (Translator), *Politics* (Oxford World's Classics) Paperback – May 15, 2009 and Anton, J. P. & A. Preus (eds.), *Aristotle's Ethics: Essays in Ancient Greek Philosophy*, vol. 5. Albany: The State University of New York Press, 1991.

⁷ However, under the concept of *Bai 'Mu' ajjal*, parties may enter into installment sales and other deferred payment transactions in which the total required payments exceed today's cash-equivalent price. These arrangements are valid as long as all future payment amounts are fixed at the time of sale and are contractually identified as being the principal amount of the selling price, not interest. The concepts of the time value of money and present-value discounting also are permitted because “present value” merely expresses the economic equivalence between deferred payments and an asset's current value, but does not involve parties explicitly entering into an interest-bearing transaction.

Chapter 2 – Ethical Principles and Reasoning

All these views contrast with the free market perspective articulated by philosopher Jeremy Bentham in the late 18th century:

*No man of ripe years and of sound mind, acting freely, and with his eyes open, ought to be hindered, with a view to his advantage, from making such bargain, in the way of obtaining money, as he thinks fit: nor [shall] anybody [be] hindered from supplying him, upon any terms he thinks proper to accede to.*⁸

Ethical Absolutism versus Relativism

Most ethicists disparage the notion that ethical values ebb and flow as the norms of a particular society change. Rather, they contend, societies may diverge in how they *apply* moral principles, but the core underlying principles themselves are universal. For example, virtually all societies agree on the right of privacy, but Europeans generally favor a stricter application of this principle to marketers' use of personal data gathered from observing individuals' internet searches. All societies likewise agree on the right to justice, but only some believe that juries, rather than judges, are better at imparting justice. Nonetheless, it is indisputable that cultural norms, or at least their implementation, differ among societies on a diverse set of business issues, such as scientific experimentation on animals and child labor protection.

Some members of the accounting profession have acknowledged that disagreements among countries and cultures about whether a particular business practice is ethical make it challenging to implement a uniform global set of professional standards. As one critic of the IFAC Code observed, “differing cultures and levels of economic development are likely to cause professionals in many countries to find some part of international guidelines [to be] antithetical to the social and economic environment in which they work.”⁹

An Introduction to the AICPA Code

An Overview

The AICPA Code is comprised of a Principles section and three substantive sections. These latter sections primarily govern the conduct of Members in Public Practice and Members in Business, but a third section covers All Members, including those who are retired or temporarily unemployed.

⁸ Jeremy Bentham, *Defense of Usury* (London: Payne & Foss, 1787).

⁹ Jeffrey Cohen, “Cultural and Socioeconomic Constraints on International Codes of Ethics: Lessons from Accounting,” *Journal of Business Ethics* 11 (1992): 687–700.

Chapter 2 – Ethical Principles and Reasoning

The Principles section presents the AICPA Code’s broad framework.¹⁰ These Principles are advisory in nature and do not subject violators to disciplinary action. In contrast, violations of the Code’s later sections can result in disciplinary action. Individuals accused of violating these later sections have the burden of justifying their conduct to the AICPA Disciplinary Committee.

The Core Principles of Professional Conduct

This chapter will now examine the Principles section of the Code of Conduct.¹¹

FIGURE 2-2 The Six Principles of the AICPA Code

Principle	Core Concept
First	Adhere to professionalism
Second	Serve the public interest
Third	Act with integrity
Fourth	Be objective and free of conflicts of interest
Fifth	Act with due care
Sixth	Possess adequate training and skill

The Code of Conduct identifies six principles that are applicable to all members of the accounting profession. These six principles are the Responsibilities Principle, the Public Interest Principle, the Integrity Principle, the Objectivity and Independence Principle, the Due Care Principle, and the Scope and Nature of Services Principle.¹²

Responsibilities

The *Responsibilities Principle* states:

In carrying out their responsibilities as professionals, members should exercise sensitive professional and moral judgments in all their activities.

¹⁰ The citations for topics in the Preface, such as the Principles, are referred to by the numeral “0,” whereas the later, substantive sections are cited as parts 1, 2, and 3, respectively. The IFAC Code has three similar substantive sections, but the order of presentation is different.

¹¹ AICPA Code Section 0.300. Later chapters will examine the later sections of the AICPA Code that establish substantive rules of conduct.

¹² IFAC Code Section 100.5 expresses the fundamental principles of professional conduct to be Integrity, Objectivity, Professional Competence and Due Care, Confidentiality, and Professional Behavior. The Association of Government Accountants’ Code states similar principles. The IMA Code’s principles are Honesty, Fairness, Objectivity, and Responsibility.

Chapter 2 – Ethical Principles and Reasoning

An occupation typically is considered to be a profession if its members require extensive formal education, possess specialized skills, make a lifetime commitment to continual self-improvement, exercise independent judgment, and possess a dedication that rarely ends when the office door shuts at the close of a workday. Most professions also require their members to pass a rigorous exam and comply with state licensing mandates.

For centuries, there were only three widely recognized professions: medicine, law, and divinity. Over time, other occupations, such as architecture, pharmacy, nursing, engineering, and teaching, established themselves as professions. Accounting has only comparatively recently been considered a profession.

Accounting is not only a profession; it is a unique profession. Unlike other professionals, accountants largely operate through self-governance. The Financial Accounting Standards Board, or **FASB**, and the Governmental Accounting Standards Board, or **GASB**, are nongovernmental entities that establish the detailed rules that comprise generally accepted accounting principles, or GAAP. The AICPA's Auditing Standards Board similarly establishes the rules that comprise *generally accepted auditing standards*, or **GAAS**, for audits of nonpublic companies.

State regulators traditionally have deferred to these private rule-making bodies, and the SEC, a federal agency, historically has recognized the FASB's rules as authoritative.¹³ In the aftermath of scandals that rocked our financial markets, however, the federal government changed the regulatory landscape by enacting the Sarbanes-Oxley Act, which created the Public Company Accounting Oversight Board (PCAOB) to oversee audits of companies traded on stock exchanges. By creating the **PCAOB**, Congress “ended more than 100 years of self-regulation at the federal level by the public company audit profession.”¹⁴

Example 2-2

When the FASB first proposed changes to the accounting rules for employee stock options, many corporations vigorously complained that implementation of these rules would be too burdensome. Some members of Congress even proposed a new law, called the *Broad-Based Stock Option Plan Transparency Act*, to prevent the FASB proposal from taking effect. Did the SEC have the power to override the FASB rules for publicly traded corporations without passage of this legislation?

¹³ Financial Reporting Release No. 1, Section 101, reaffirmed in the SEC's April 2003 Policy Statement. All authoritative rules of GAAP are contained in the Accounting Standards Codification.

¹⁴ Ernst and Young, “The Sarbanes-Oxley Act at 10” (New York: Author, 2012).

Solution

Yes. The SEC has the authority to regulate financial reporting by publicly traded companies. However, the SEC rarely exercises its power to override FASB rules.

The Public Interest

The *Public Interest Principle* states:

Members should accept the obligation to act in a way that will serve the public interest, honor the public trust, and demonstrate commitment to professionalism.

Do members of a profession owe a duty only to their clients, or do they also owe a duty to the broader society? This issue long has been debated, with various professions reaching different conclusions.

The Viewpoint of Other Professions

In the legal profession, attorneys explicitly are required to act with a single-minded dedication to their clients' best interests. For example, criminal defense attorneys must strive to obtain a Not Guilty verdict, even if their client is indeed guilty and a danger to society. Similarly, tax attorneys are subject to disciplinary sanctions if they voluntarily inform the IRS about a client who filed a false tax return.

In the medical field, pharmacists and doctors likewise must consider only their patients' well-being. These professionals must inform their patients about the most effective drugs and medical procedures, without regard to the added costs that Medicare and others may incur.

In the engineering profession, the tension between serving clients and serving the public has evolved over time. During 1912, the profession's Code of Ethics required an engineer to make "the protection of a client's or employer's interests his first professional obligation."¹⁵

However, by 1947, the profession enacted a more expansive set of duties that required an engineer to "discharge his duties with fidelity to the public, his employers, and clients, with fairness and impartiality to all."¹⁶ Thus, this revised Code of Ethics recognized that engineers have a dual obligation to public as well as private-sector interests.

More recently, some might say that the engineering profession completed its transformation from a caterpillar to a majestic butterfly. According to a 1974 Canon of Ethics revision, engineers "shall hold paramount the safety, health, and welfare of the *public* in the performance of their professional duties."¹⁷

¹⁵ American Institute of Electrical Engineers' Code of Ethics.

¹⁶ Engineers' Council for Professional Development.

¹⁷ National Society of Professional Engineers' "Code of Ethics for Engineers."

The Viewpoint of the Accounting Profession

How does the accounting profession balance its twin responsibilities to serve both private and public interests? Like the modern-day engineering profession, the accounting profession generally believes that the broader public interest takes precedence over a client’s parochial interests because “. . . credit grantors, governments, employers, investors, the business and financial community, and others . . . rely on the objectivity and integrity of certified public accountants to maintain the orderly functioning of commerce” “This reliance imposes a public interest responsibility on . . . [accountants for] the collective well-being of the community of people and institutions that the profession serves.”

Accordingly, in performing an audit, an accountant acts as a public guardian that is beholden solely to readers of financial statements. This duty to the public reigns supreme, even though a client selects and pays for its auditor’s services. A similar duty applies to accountants in tax practice. If a client insists on claiming an impermissible tax deduction, an accountant’s foremost duty is to the governmental taxing authority, not the client.

Despite the public’s preeminence, it is not always a simple task to determine what the “public interest” is. To illustrate this dilemma, assume that your audit client currently has insufficient funds to meet its pension obligations. Upon introducing its new product line, however, this client will likely obtain sufficient funds. Should you insist that your client disclose this temporary shortfall in liquidity in its public financial statements?

If the company discloses its lack of funds, experienced workers will depart, which will curb the company’s efforts to innovate and cause large losses to investors, suppliers, and distributors. All levels of government will suffer too as laid-off workers draw unemployment and other social welfare benefits.

On the other hand, if an auditor does not disclose the company’s liquidity problems, the investing public’s faith in the reliability of financial reports will suffer, harming capital formation over the long run.

In balancing these considerations, the accounting profession has concluded that timely, truthful financial disclosures are essential to an efficient market economy, even if narrow constituencies are adversely affected in the short run. As former Supreme Court Justice Brandeis once said, “Sunlight is . . . the best of disinfectants.”¹⁸

¹⁸ <http://www.brandeis.edu/legacyfund/bio.html>.

Chapter 2 – Ethical Principles and Reasoning

Example 2-3

In reviewing your employer’s financial statements, you discovered that sales revenues earned in Year 1 were improperly deferred until Year 2. As a result, you have recommended that the company revise its financial statement to report higher sales in Year 1 and lower sales in Year 2. However, your accounting department supervisor has refused, saying that a revision “would just confuse investors . . . and total sales is the same either way.” She also insists that the company’s financial statements for Year 1 were more conservative because reported sales were lower than the actual sales results. Should you insist that prior-year financial statements be restated?

Solution

Yes. Although reported sales were too low last year, a restatement would result in higher sales revenues for Year 1 and correspondingly lower sales revenues in Year 2. Readers of the company’s financial statements have an interest in knowing whether the trend in sales is upward or downward. The public also has an interest in knowing whether the company’s internal controls are adequate to identify financial reporting deficiencies.

Integrity

The *Integrity Principle* states:

To maintain and broaden public confidence, members should perform all professional responsibilities with the highest sense of integrity.

In *Star Wars*, a Jedi Knight proclaims: “Let there be truth between your heart and the Force. All else is transitory.”¹⁹ Integrity is the character trait of being forthright and truthful, even when others exert contrary pressures. As one country rock tune expresses this principle, you can’t be a “puppet on a string . . . you’ve got to stand for something or you’ll fall for anything.”²⁰

Accountants must always display honest and straightforward behavior, without subordinating their judgment to others. Integrity also requires compliance with the spirit of a rule, and not just its formal articulation. Reliance on technicalities and loopholes as a subterfuge for avoiding ethical conduct violates the fundamental principle of integrity.²¹

Billionaire investor Warren Buffett profoundly once stated the importance of integrity as follows:

Somebody once said that in looking for people to hire, you look for three qualities: integrity, intelligence, and energy. And if you don’t

¹⁹ For *Star Wars* fans, it is intriguing to see the parallels between the AICPA Code and the Jedi Code.

²⁰ Aaron Tippin, “You’ve Got to Stand for Something.”

²¹ Integrity is both an aspirational principle of the AICPA Code and an enforceable rule known as the *Integrity and Objectivity Rule, AICPA Code Section 1.100.*

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have the first, the other two will kill you. You think about it; it's true. If you hire somebody without [integrity], you really want them to be dumb and lazy.

Example 2-4

For the past few years, your work as an assistant controller required you to regularly interact with a chief controller who was rude and insulting. You still cannot believe that, while looking at a lovely family photo on your desk, she said that your family must “drink ugly juice with every meal.”

After the chief controller recently resigned to start a higher-paying job, you were contacted to verify certain facts about her dates of employment and reasons for departure. After carefully reviewing the Code of Conduct, you correctly concluded that it does not contain any specific rules about responding to job reference inquiries. As a result, out of spite, you stated that your company's former chief controller was terminated months ago due to an “unexplained embezzlement from the company's bank account.” Did you violate the Code of Conduct?

Solution

Yes. Ethics codes cannot contemplate every possible eventuality or transaction. Accordingly, accountants are expected to conform to the spirit of an ethics code concerning integrity and professionalism. Although your desire for revenge is understandable, you should not have spitefully subordinated your principles of ethical behavior for personal advantage.

FIGURE 2-3

The Integrity Hypocrite²²

While applying for college, many of us were told: *Be yourself!* For many years, MIT Dean of Admissions Marilee Jones repeatedly gave similar advice to eager applicants.

There was only one problem with the Dean's advice—she had misrepresented her own credentials to get ahead, and she got caught. According to MIT, Jones claimed to have received degrees from three colleges, but she never graduated from any of them.

Before being forced to resign, the disgraced dean had written that “holding integrity is sometimes very hard to do because the temptation may be to cheat or cut corners . . . But just remember that ‘what goes around comes around,’ meaning that life has a funny way of giving back what you put out.”

Indeed, it does.

²² New York Times, “Dean at M.I.T. Resigns, Ending a 28-Year Lie,” April 27, 2007.

Objectivity and Independence

The *Objectivity and Independence Principle* states:

A member should maintain objectivity and be free of conflicts of interest in discharging professional responsibilities. A member in public practice should be independent in fact and appearance when providing auditing and other attestation services.

The public unhesitatingly can rely on financial statements only if members of the accounting profession approach their tasks with impartiality. As a result, the Code of Conduct implores accountants in public practice to always approach their work with objectivity, free of biases that impair intellectual honesty. In addition, accountants must avoid any conduct that might cause a skeptic to doubt their impartiality.

Former KPMG audit partner Scott London, who pleaded guilty in 2013 to insider stock trading, provides an extreme illustration of what not to do. According to a wiretapped phone conversation recorded by the FBI, London told his co-conspirator, “. . . when I know that it’s gonna start happening, what you do is you start just buying in small blocks, right, so it doesn’t draw attention and then, you know, then it doesn’t look unusual at all.”²³ Although London’s Los Angeles office overlooked the famed *Hollywood* sign, this was not dialogue from a bad movie. London’s misconduct was reckless reality, not fanciful fiction.

To quote Warren Buffett once again, “It takes twenty years to build a reputation and five minutes to ruin it. If you think about that, you’ll do things differently.” In the case of disgraced auditor London, it took thirty years for him to rise to the top of his profession, but only a few moments for it all to come crashing down.

Example 2-5

A tax return preparer has recommended that her corporate client install specialized software. According to the tax return preparer, this software will improve the company’s compliance with certain intricate tax rules and will save the client accounting fees over the long run. As part of this recommendation, the tax return preparer disclosed to her client that she will receive a 20% commission from the software developer for selling and installing the software. Is this tax return preparer’s financial arrangement permitted under the Code of Conduct?

²³ <http://goingconcern.com/post/update-complaint-says-scott-london-admitted-tipping-bryan-shaw-about-five-kpmg-clients/section/0/1>.

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Solution

Yes. By making this candid disclosure, the tax return preparer enabled her client to make a fully informed decision that took into account her advisor's potential bias.

It is easy to grasp why an outside auditor must adhere to high standards of objectivity and avoid even the appearance of a conflict of interest. However, should this same standard apply to industry accountants who perform accounting services solely for their employer?

According to the Code of Conduct, management accountants unavoidably have a conflict of interest in performing their job duties because their entire livelihoods inextricably are linked to their employers' continuing prosperity. As a result, it would be impossible and nonsensical to expect management accountants to remain free of conflicts of interest in performing job duties for their employer. Nonetheless, apart from this narrow exception, all accountants must maintain objectivity in their professional activities.

Example 2-6

You recently stopped practicing accounting to become a career placement recruiter. You receive a commission from a prospective employer when you successfully help it fill a job opening for accounting and finance personnel. To promote your qualifications, you proudly mention on your website that you are a member of the AICPA and have 15 years of prior public accounting experience.

A prospective job candidate recently contacted you, hoping to obtain his "dream job" of working for a hedge fund. You suspected that his experience in government contract accounting made it highly unlikely that a hedge fund would be interested in hiring him. However, you knew that you could easily place him in a job opening at a nearby defense contractor, so you told him that you could "get him his dream job." Did you violate the Code of Conduct?

Solution

Yes. Although you no longer practice public accounting, the Code of Conduct applies to all members of the AICPA, regardless of whether they currently practice accounting. By promising to find this candidate a job at a hedge fund, you acted deceptively and without integrity.

Due Care and the Scope and Nature of Services

The *Due Care Principle* states:

A member should observe the profession's technical and ethical standards, strive continually to improve competence and the quality of ser-

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vices, and discharge professional responsibility to the best of the member's ability.

Furthermore, an allied concept, the *Scope and Nature of Services Principle*, states:

A member in public practice should observe the Principles of the Code of Professional Conduct in determining the scope and nature of services to be provided.

In summary, these two principles allow accountants to accept a client assignment only if they have the training, skills, and time to perform the task with a high level of professional excellence.

No one, of course, can possibly be an expert at everything. Accordingly, it is acceptable for accountants to commit to a task as long as competent mentors and resources are available to fill in gaps in their knowledge. It is also acceptable to delegate tasks to others, as long as a professional assignment is properly planned and adequately supervised.

Ultimately, accountants are the sole judge of whether they have the professional competence to perform a task with due care.

Example 2-7

Your accounting firm recently obtained a great new client. However, this client has complex mining operations, including a copper mine located in Peru. To serve this client, the lead partner in charge of the engagement asked at a firm meeting, "Who has the integrity . . . the guts . . . and the intellectual honesty . . . to handle this awesome new client's foreign currency and copper commodities trading transactions?"

You wanted to challenge yourself by accepting this assignment, but you remembered that you got a low grade in college seven years ago on an Advanced Accounting midterm covering foreign currency and commodities transactions. However, in recent years, you have obtained substantial experience working on accounting issues involving foreign currency and derivatives trading. May you ethically accept this assignment?

Solution

Yes. The relevant test is whether you have the skills, training, and access to mentoring to perform the tasks with a high level of professional excellence. Your grade in college seven years earlier largely is irrelevant.

The Development of Moral Reasoning

Psychologist Lawrence Kohlberg's pioneering research observed that people sequentially reach more advanced levels of ethical reasoning over

time due to training and life experience. **Kohlberg’s Stages of Moral Development** model identifies six different stages of moral reasoning, which he grouped into three paired sets, referred to as Levels One, Two, and Three.²⁴

Kohlberg’s Stages of Moral Development

Level One: Focus on Self

At Level One of moral development, individuals only are concerned with their own punishment and rewards. This level is called the *Pre-Conventional Level*, and it is divided into two stages.

Stage One typically is associated with young children. Before reaching adolescence, children often make decisions based on whether their conduct will result in punishment. Young children act obediently solely out of fear of punishment or disapproval from an authority figure, such as a parent or teacher.

At Stage Two, people still focus on their self-interest, but they begin to notice that that punishment varies according to the severity of a person’s misconduct. To illustrate, imagine that a young child is thinking about hitting another child who lives nearby. At Stage One, the child simply acts, or refrains from acting, based on the likelihood of receiving swift punishment. At Stage Two, however, children notice that malicious actions result in severe punishment, but well-intentioned acts, such as acting out of self-defense or to protect a nearby child from bullying, result in little or no punishment.

Individuals at Stage Two also realize that cooperative behavior today creates an implicit exchange that earns rewards in the future. For instance, a child at Level Two might agree to perform chores for a parent not out of a fear of punishment, but out of a desire to secure a future reward, such as a later weekend curfew.

Although Level One often is associated with children, many adults exhibit Level One development as well. Because individuals at Level One exclusively focus on themselves, rather than the welfare of their employer, customers, or subordinates, they are poor candidates for leadership positions within an organization. They also need to work in environments where rigid rules of behavior are imposed and sanctions are swiftly enforced.

²⁴ Lawrence Kohlberg, “Stage and Sequence: The Cognitive Developmental Approach to Socialization,” in *Handbook of Socialization Theory and Research*, ed. D. Goslin (Chicago: Rand McNally, 1969), 347–480.

Level Two: Focus on Group Expectations

At Level Two, known as the *Conventional Level*, people shift from acting out of a fear of punishment to behaving out of a desire to please others. Like the preceding level, Level Two is comprised of two stages, called Stage Three and Stage Four.

Stage Three is reached when individuals make moral decisions based on the expectations of others in their immediate social sphere, such as friends and family members. For example, people at this stage might refrain from drunk driving or cheating on a test principally out of a concern that getting caught or arrested would humiliate their families.

At Stage Four, people broaden the scope of the sphere that influences their decisions to encompass society as a whole. Typically, at this level of development, people recognize that laws are important expressions of societal values and that one should abide by laws.

This level is called the *Conventional Level* because individuals typically exhibit this level of development, with some never reaching this level and comparatively few progressing beyond it to the next level.

Level Three: Focus on Inner Principles

Level Three, called the *Post-Conventional Level*, involves the development of higher-order values and principles. This level, too, includes a pair of stages.

At Stage Five, individuals understand that laws reflect a majority consensus, but that reasonable people can formulate differing opinions about whether a law should be changed or obeyed. Individuals at this stage intellectually question the social values underlying certain laws and believe in pursuing needed changes through democratic processes.

The final stage, Stage Six, is achieved when individuals behave in accordance with their own moral reasoning about abstract concepts, such as integrity and justice, without regard to the dictates of the law. At this stage, people have the ability to “step into the shoes” of others to evaluate rules from alternative perspectives. They also have fully formed consciences that enable them to reject conventional societal rules, despite knowing that their disobedience could result in penalties or imprisonment.

Acts of civil disobedience that violated racial segregation laws of the early 1900s exemplify Stage Six conduct. For example, if a black child was extremely thirsty but the only drinking fountain nearby legally was labeled *For Whites Only*, a black parent who prioritized her child’s health and comfort in disregard of the law engaged in Stage Six conduct.

Based on his observations, Kohlberg concluded that few people consistently exhibit Stage Six behavior.

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FIGURE 2-4 Kohlberg’s Stages of Moral Development

Level	Focuses on:	Stage	Description
1	Self	1	Act purely out of self-interest. Will disobey rules as long as they can avoid punishment.
		2	Still act in self-interest, but understands that others also have desires and that punishment is proportionate to the severity of misconduct.
2	Group expectations	3	Aim to please others in close proximity, such as family and friends.
		4	Aim to please others in broader society by complying with laws.
3	Inner principles	5	Recognize that some laws reasonably can be challenged and changed
		6	Adhere to inner conscience, even if that may violate a law.

Example 2-8

In researching the various stages of moral development, Kohlberg developed a vignette about a devoted husband named Heinz. Heinz wants to obtain a life-saving drug for his dying wife, but cannot afford it. When the pharmacist refuses to lower the price of this drug, Heinz contemplates stealing it from the pharmacist.

Assume that Heinz expresses each of the following views:

- “I am not going to steal the drug because I know that I’ll be sent to jail.”
- “I am going to steal the drug because no judge would impose a severe punishment on me.”
- “I am going to steal the drug because my wife and others dear to me would approve of me doing so.”
- “I am reluctant to steal the drug because, even though my wife desperately needs it, society cannot function if people simply choose which laws they wish to abide by.”
- “My wife’s right to live is more important than the pharmacist’s right to property.”
- “I am going to steal the drug because, if the roles were reversed, I know that the pharmacist would steal the drug from me to protect his wife’s life.”

At what stage in Kohlberg’s hierarchy would a person most likely express each of the above viewpoints?

Solution

These six statements correspond, in chronological order, to Kohlberg’s six stages of moral development.

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The first two statements are consistent with Level One reasoning. They are self-focused and are concerned with the likelihood of punishment. The first statement corresponds to Stage One because it views punishment in absolute terms, whereas the second statement corresponds to Stage Two because it recognizes that the degree of punishment depends on the presence of mitigating circumstances.

The third and fourth statements reflect Level Two reasoning because they focus on acceptance by Heinz's peer group. The third statement corresponds to Stage Three because it narrowly considers the views only of Heinz's immediate family, whereas the fourth statement corresponds to Stage Four because it considers the broader views of the entire community, as reflected in its laws.

The fifth and sixth statements demonstrate that Heinz has developed sophisticated Level Three reasoning skills and has become capable of evaluating whether a law is unjust. The fifth statement illustrates Stage Five reasoning because Heinz has decided to value the preservation of human life over adherence to the law. The final statement corresponds to Stage Six reasoning because it reflects Heinz's willingness to disobey the law. It also shows that Heinz is able to reverse roles with the pharmacist to reach a conclusion from the other party's perspective.

Applying Kohlberg's Six Stages to the Accounting Profession

Advanced ethical reasoning is critical in the accounting profession because accountants often have to discern the *right* or *just* decision in circumstances where rules are ill-defined or simply absent. Industry accountants must not subordinate their judgments to their superiors, outside auditors must not subordinate their judgments to their clients, and tax professionals surely must reach fair and just determinations when a void exists in tax rules.

Various empirical studies have examined the ethical reasoning processes of accounting professionals working in public accounting firms. Using a widely accepted standardized test, one study found that moral development levels typically increase as accountants transition from junior-level staff members into senior-level staff positions with greater supervisory responsibilities.

Disturbingly, however, the stage of moral development attained by accountants drops off significantly once they become managers and partners.²⁵ It is unclear if this drop-off is due to a socialization process that discourages managers and partners from developing more-advanced reasoning. Other possible explanations are that staff members with high-

²⁵ L. Ponemon, as reported in "Ethical Reasoning Research-Accounting," in *Moral Development in the Professions: Psychology and Applied Ethics*, ed. James Rest and Darcia Narváez (Hillsdale, NJ: Erlbaum, 1994).

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er-stage moral development often are denied promotions to become managers and partners, or their personalities predispose them to leave the public accounting profession before becoming managers and partners.

Criticisms of Kohlberg’s Approach

Some researchers, such as Kohlberg’s colleague Carol Gilligan, have criticized Kohlberg for emphasizing abstract, justice-based reasoning as the dominant element of higher-stage moral development. Gilligan has contended that at advanced levels, women commonly are less focused than men are on theoretical notions of justice. Instead, she believes, women generally are more oriented toward fostering interpersonal relationships and acting compassionately toward society’s most vulnerable members.²⁶ Accordingly, Gilligan contends that Kohlberg’s emphasis on justice-based factors results in his model systematically underestimating the degree to which women exhibit advanced moral development. As one commentator summarized this difference between the sexes, “men are more willing to take a bullet to preserve their country’s liberties and freedom, while women are more likely to sacrifice for their loved ones.” Gilligan’s hypothesis that women have a greater propensity to be nurturing and compassionate has been dubbed the *ethics of care*.

Despite the plausibility of Gilligan’s contention, subsequent investigations, including research by Gilligan herself, have shown few gender-based differences in moral reasoning between male and female managers and professionals.²⁷ As a result, Kohlberg’s model remains a useful model for assessing whether individuals are suitable candidates for leadership positions in the business, government, and nonprofit sectors.

FIGURE 2-5

Want to Get a Lost Wallet Back?

Discovering that you’ve lost your wallet, along with the credit cards and identification cards it contained, is one of life’s most anxious moments. Want to know a simple trick for getting others to return your lost wallet?

In a real-world experiment, British psychologist Richard Wiseman discovered that people who find wallets lying on the street are far more likely to return them if the wallet contains a photo of a baby. Fully 88% of all such wallets were returned to their rightful owners, compared to only a 15% return rate for wallets that had no photos. Photos of puppies also fared well,

²⁶ Carol Gilligan, *In a Different Voice* (Cambridge, MA: Harvard University Press, 1982).

²⁷ Linda Trevino and Katherine Nelson, *Managing Business Ethics*, 5th ed. (New York: Wiley, 2011).

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yielding a 53% return rate, but nothing tops a terrific toddler for inspiring integrity.

Some scientists contend that our brains are programmed to protect children and families with children to ensure the survival of future generations. Others have observed that people simply find it to be much more difficult to act unethically when a victim is concrete and identifiable. As an example, for many people, cheating on taxes owed to a faceless government creates less intense feelings of shame than, say, stealing from the kind family living next door.

In gauging your own integrity in dealing with strangers, always consider whether you would act differently if you were interacting with a relative or a member of your same cultural group. And to boost the odds of getting back a lost wallet, be sure to put a photo of a cute kid in it . . . or you might one day be crying like a baby.

Making Ethical Decisions

Rest’s Four-Component Model of Ethical Decision Making

Kohlberg’s protégé, psychologist James Rest, developed a four-step action plan for making and implementing ethical decisions. This approach is known as **Rest’s Four-Component Model**.

The First Step: Moral Sensitivity

The first step in ethical decision making is to recognize that an issue involving morality is present in a particular situation. For example, assume that you have noticed that a work colleague brings her children to her office when the company is closed so they can complete school homework projects using company printers and supplies. Some might consider this unauthorized use of company property to raise a moral issue. Others might be glad to see children diligently doing their schoolwork and not perceive a moral issue to even be present.

To enhance your moral sensitivity, try to view actions from different perspectives, and openly discuss issues with others who may have differing viewpoints.

The Second Step: Moral Judgment

Once a moral issue has been identified, the second step is to decide whether the conduct is right or wrong. For example, you might decide that a colleague’s use of company property is acceptable because the company’s owner is family oriented, and the property used is of minor

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value. Alternatively, you might decide that the use of company property without express permission is wrong.

To improve your moral judgments, try to think about how other cultures and communities evaluate right and wrong. Also, consider whether certain models of thought, such as cost–benefit analysis, might aid your determination.

The Third Step: Moral Intent

After determining what the morally correct outcome is, the third step is to formulate the actions that you are prepared to initiate to achieve this outcome. If incentive systems such as cash bonuses or promotions are in place to reward adherence to moral actions, this step is relatively easy. However, in many cases, action might be met with disapproval that might adversely affect your career advancement, friendships, or financial well-being. In these situations, you must weigh the potential costs of acting against the benefits of preserving the status quo.

For example, assume that you have decided that your colleague’s use of company resources for her children’s homework projects is wrong. If you inform the company’s owner, you might receive praise, or even a promotion, for your diligence. On the other hand, fellow workers who can influence your career advancement and work assignments may ostracize you for informing on your colleague.

Before establishing a course of action, restrain your emotions, identify the obstacles that lie ahead, and be pragmatic about what you can, or cannot, accomplish.

The Fourth Step: Moral Character

The final step is to muster the moral character to implement intended actions. This requires persistence, energy, belief in your strategic plan, and the mental toughness to overcome opposition.

For example, if you are concerned about a colleague using company resources for her personal benefit, locate others who share your concern and can corroborate your observations. Also, have the fortitude to do the right thing, even in the face of adversity.

Example 2-9

As you were leaving your accounting job at a large retail store late one evening, you heard gunshots. As you practically tripped over a bleeding man lying on the ground in the store’s parking lot, you instinctively wanted to try to help him. However, you remembered that, due to issues of legal liability, the company has a strict policy that forbids workers from interceding in acts of violence that

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take place on company property. According to the company policy, you were required to call the police department, but not attempt to render aid or get physically involved yourself. To reinforce this policy, the company even has posted signs in the workers' lounge area that clearly state: *Workers who disobey this policy will be subject to immediate termination—no exceptions.*

How would you apply Rest's Four-Component Model to this situation?

Solution

Your first step is to recognize the moral issue: Is attempting to aid a severely injured person more important than risking the loss of your job?

Second, you must make a moral judgment: Will the world be a better place if I attempt to personally assist this bleeding man? Or, should I wait for skilled paramedics and law enforcement officers to arrive so I do not inadvertently injure this bleeding man further?

Third, you must formulate the intent to pursue the correct course of action. Should you grab a first aid kit kept in an employee work area, should you shout to see if anyone with medical training is nearby, or should you call the police department and stand prepared to give them pertinent facts and directions?

Finally, if you decide to provide assistance in disregard of company policy, you must muster the focus and energy to carry out your plan without hesitation.

The Accounting Profession's Models of Ethical Decision Making

The Code of Conduct has developed a general framework for accounting professionals to use in resolving ethical conflicts.²⁸ Global CPA firm KPMG has expressed this framework succinctly using the acronym CARE:

- Consider all the facts,
- Assess the available alternative courses of action,
- Review the ethical issues,
- Evaluate the consequences of each alternative course of action.

Example 2-10

You work as an internal auditor for Anochem, Inc. Anochem supplies a strong, heat-resistant alloy that is used in aircraft engines, power plants, and blast furnaces. Most of Anochem's customers are large enterprises, utilities, and government-owned airlines.

²⁸ AICPA Code Section 1.000.020. IFAC Code Section 100.20. Encourages accountants to consider the following factors: (a) relevant facts; (b) ethical issues involved; (c) fundamental principles related to the matter in question; (d) established internal procedures; and (e) alternative courses of action.

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Your company's website posts set prices for its various product offerings. However, if a customer's monthly purchases exceed specified dollar volumes, the customer can negotiate with Anochem to receive up to an 8% price rebate. Anochem automatically credits this rebate to customer accounts within 60 days, unless the customer specifies in advance that it wants to receive this rebate by bank wire transfer or in cash.

In reviewing customer cash rebates at year-end, you noticed that purchasing agents for several of your largest customers drive long distances to Anochem's headquarters to receive their company's volume rebates in cash. When you asked your supervisor why this occurs, she simply smiled at you, winked, and said, "It's good for business." Upon investigating further, you noticed that the purchasing agent for a Latin American, government-owned airline flies to Anochem's U.S. headquarters to collect his company's rebate in cash. What should you do?

Solution

Step 1: Consider all the facts.

The key facts are that:

- Customers include businesses owned by foreign governments.
- Some customer representatives travel long distances to obtain rebates in cash.

Step 2: Assess the alternatives.

You have several choices:

- You can tell your supervisor that you suspect that some customer representatives are keeping the cash rebates for themselves as secret kickbacks.
- You can go above your supervisor and express your concerns to the company's board of directors, audit committee, or chief financial officer.
- You can request personal taxpayer identification numbers from client personnel and tell them that Anochem will report their cash rebates to the IRS on a year-end Form 1099 tax statement.
- You can inform federal authorities that cash rebates received by foreign government officials likely violate the Foreign Corrupt Practices Act.
- You can inform your customers' Boards of Directors that their purchasing agents are receiving rebates in cash.
- You can rationalize that some clients pick up their rebates in cash because they consider bank wire transfers to be unreliable.
- You can remain silent and avoid any risk to your job.
- You can remain silent and tell your supervisor that, in return, you want an excellent recommendation letter so you can obtain a new job.
- You can resign in protest.

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Step 3: Review the ethical issues.

- Is your personal retention of frequent flyer miles on company-paid travel a similar kind of ethical violation? Or, is this situation different?
- Do you have a legal duty to act? Do tax laws or the Foreign Corrupt Practices Act compel you to inform appropriate authorities?
- Do you have a moral duty to act? Is your company engaged in misconduct, or it is merely facilitating misconduct by an outside customer representative?
- Do you also have a moral duty to fellow employees to remain silent so disclosure of these presumed kickbacks will not adversely hurt company sales and result in layoffs?
- If you do have a moral duty to act, what action should you take? Should you inform your company's board of directors, chief financial officer, auditor, or tax preparer? Should you inform the chief executive officers of the companies that are your customers?
- If you communicate your concerns to others in the organization, can you persuade them that maintaining the company's reputation for integrity is, in the long run, good for business?
- Does the Code of Conduct provide any guidance on this issue?
- Should you consult with your company's general counsel, a private attorney, a clergyman, or trusted friends and relatives?

Step 4: Evaluate the consequences.

- If you communicate your concerns to your supervisor or others higher in the organization, you may lose your job or sacrifice pay increases and promotions.
- If you communicate your concerns to outside customers, they may shift their purchases to others, which could lead to layoffs at your company.
- If you fail to communicate your concerns, you perhaps could be exposed to legal liability.
- If you fail to communicate your concerns, you might feel remorse for betraying your core values.
- If you resign in protest, family and friends might commend you for pursuing the morally correct action.
- If you resign in protest, you might be proud of yourself for pursuing the morally correct action.
- If you resign in protest, you might struggle to find a comparable job.

Is Ethical Decision Making Truly Rational?

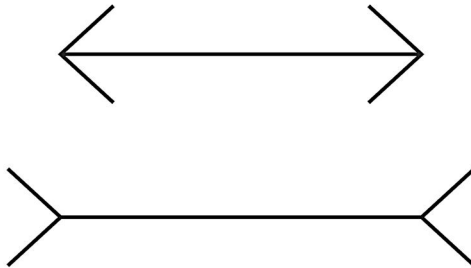
The decision-making approaches discussed thus far have assumed that people spend substantial time and effort in evaluating ethical dilemmas.

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Modern researchers believe, however, that many ethical decisions are made quickly based on automatic *gut feelings* to conserve our limited time and effort. For instance, Daniel Kahneman, a Nobel Prize-winning economist, contends that our brains engage in *dual processing*. He conceptualizes our brains as using **System 1** for making rapid, intuitive decisions and **System 2** for mental activities that require deliberative, controlled analysis, such as preparing a bond amortization schedule.

Please refer to Figure 2-6. Professor Kahneman illustrates these two thought systems by posing the following question: How much longer is the bottom line than the top line?

FIGURE 2-6 Which Line Is Longer?



Your brain's System 1 tells you that the bottom line is longer than the top one. However, careful System 2 analysis, aided by a ruler or straight edge, proves that both lines are exactly the same in length.²⁹

To improve our ethical decision making, some psychologists believe that we need to tame the *emotional dog* of System 1 to prevent it from dominating the *rational tail* of System 2. That is, sound decisions require us to at times override our reflexive, intuitive responses and make the effort to use deliberative analysis.³⁰

Solution to “Am I Ethical?”

[D]

Do not confuse the issue of whether an act is legal with the issue of whether it is ethical. The hunter might have a reasonable legal argument, but the legality or illegality of a decision does not dictate its ethical char-

²⁹ Daniel Kahneman, *Thinking, Fast and Slow*, New York: Farrar, Straus and Giroux, 2011.

³⁰ Some researchers have concluded that people make most ethical decisions using System 1, and then use the deliberative analysis of System 2 to rationalize these instantaneous System 1 reactions after the fact. See, for example, Jonathan Haidt, “The Emotional Dog and Its Rational Tail: A Social Intuitionist Approach to Moral Judgment,” *Psychological Review* 108, no. 4 (2001): 814–834.

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acter. Similarly, the policeman's contractual duty to carry a gun and the frightened tenant's justification for owning a gun present sympathetic arguments. However, ethics involves deciding right from wrong. If your decision is based on a desire to provide a safe living environment in which all tenants can live without fear of gun-related accidents and violence, your decision is ethical, even if several tenants unfortunately suffer adverse consequences.

Review Questions

1. What concept focuses on how people should behave?
 - A. Law
 - B. Coerciveness
 - C. Ethics
 - D. Relativism

2. What is the reason the accounting profession is unique compared to other professions?
 - A. Its members must comply with state licensing mandates
 - B. It is largely self-governed
 - C. It acts with a single-minded dedication to clients' best interests
 - D. Its members must pass a rigorous exam

3. Of the following, which violates an accountant's fundamental principle of integrity?
 - A. Reliance on technicalities
 - B. Conflict of interest by an industry accountant
 - C. Delegation of tasks to others due to a gap in knowledge
 - D. Reliance on the spirit of a rule

4. In which situation is advanced ethical reasoning in the accounting profession critical?
 - A. Conventional societal rules can be challenged
 - B. There is a desire to please others
 - C. Rules are simply absent
 - D. A law should be changed or disobeyed

Review Answers

1.
 - A. Incorrect. The law is not a concept that focuses on how people should behave. Laws represent society's consensus about how citizens must, at a minimum, behave.
 - B. Incorrect. Coerciveness is not a concept that focuses on how people should behave. Coerciveness involves the enforcement of something upon somebody, and not simply how they should act.
 - C. **Correct.** Ethical concepts focus on how people should behave.
 - D. Incorrect. Relativism is not a concept that focuses on how people should behave. Ethical relativism asserts that rules of morality evolve over time and vary among cultures, religious, and political structures.

2.
 - A. Incorrect. The accounting profession is not unique compared to other professions because its members must comply with state licensing mandates. Most professions require their members to comply with state licensing mandates.
 - B. **Correct.** Unlike other professionals, accountants largely operate through self-governance.
 - C. Incorrect. Acting with a single-minded dedication to its clients' best interests is not what sets accounting apart from other professions. Unlike accounting professionals that have a dual responsibility, attorneys and doctors are required to act with a single-minded dedication to their clients' best interests.
 - D. Incorrect. The accounting profession is not unique compared to other professions because its members must pass a rigorous exam. Most professions require their members to pass a rigorous exam.

3.
 - A. **Correct.** An accountant's reliance on technicalities and loopholes as a subterfuge for avoiding ethical conduct violates the fundamental principle of integrity.
 - B. Incorrect. Conflict of interest by an industry accountant does not violate the fundamental principle of integrity. Industry, or management, accountants have a conflict of interest in performing their jobs because their entire livelihoods inextricably are linked to their employers' prosperity.
 - C. Incorrect. It is not a violation of an accountant's fundamental principle of integrity if tasks are delegated to others due to a gap in knowledge. It is acceptable to delegate tasks to others, as long as professional assignment is properly planned and adequately supervised.

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- D. Incorrect. Reliance on the spirit of a rule does not violate an accountant's fundamental principle of integrity. Integrity requires compliance with the spirit of a rule, and not just its formal articulation.
4. A. Incorrect. The proposition that conventional societal rules can be challenged is not a situation where advanced ethical reasoning in the accounting profession is critical. Individuals may have developed consciences that enable them to reject conventional societal rules, despite knowing that such disobedience could result in penalties.
- B. Incorrect. Desiring to please others is not a situation in which advanced ethical reasoning in the accounting profession is critical. People often shift from acting out of fear of punishment to behaving out of a desire to please others.
- C. **Correct.** Advanced ethical reasoning is critical in the accounting profession because accountants often have to make decisions in circumstances where rules are ill defined or simply absent.
- D. Incorrect. The fact that a law should be changed or disobeyed is not a situation in which advanced ethical reasoning in the accounting profession is critical. Reasonable people can formulate differing opinions about whether a law should be changed or obeyed

Chapter 3

The Core Philosophies

Learning Objectives

- Spot the chief advantage of utilitarianism
- Pinpoint when lying is permissible according to utilitarians
- Determine what neuroscientists using brain scans believe occurs when individuals confront moral dilemmas

Am I Ethical?

For many years, Apple Inc.'s famed CEO, Steve Jobs, struggled with an undisclosed illness. At various times, Apple informed the media that Jobs' illness was "a hormone imbalance," "simple and straightforward," and "a common bug."¹ In fact, Jobs had pancreatic cancer. When Jobs disclosed in January 2009 that his illness was "more complex" than he originally had anticipated, investors reacted swiftly, causing Apple's stock price to fall by over 5%. Three years later, the world mourned. Steve Jobs had died at age 56.

Did Apple act ethically?

- a. No, because the company owed a duty of full disclosure to all company stakeholders, including its employees
- b. No, because the company violated a core ethical principle
- c. Yes, because a person's medical condition is a sensitive personal matter
- d. Yes, because SEC guidelines justifiably protected Jobs' right of privacy

The **solution** is revealed at the end of the chapter.

Introduction

Some fashion designers create elegant *haute couture* for the runways of Milan and Paris, but sacrifice practicality. Others create clothing for the mass market, weighing the cost of every stitch against its benefits.

Ethical philosophies have a lot in common with fashion. Some ethical frameworks are elegant, but somewhat impractical. Others aim for an

¹ http://www.gsb.stanford.edu/sites/default/files/12_CEOHealthDisclosure.pdf.

Chapter 3 – The Core Philosophies

efficient outcome that weighs the costs of an ethical choice against its benefits.

This chapter will explore the two philosophical frameworks that are most commonly applied in resolving ethical dilemmas. These philosophies are known as *utilitarianism* and *deontology*.

The Core Philosophies

Most of us want to do the *right* thing, but we are not always certain what that is.

One ethical decision-making approach focuses on the end result of a particular course of action. If an act improves the collective happiness of those who are affected by it, a decision is judged to be ethical. This approach is called **consequentialism** because it only is concerned with an act's ultimate consequences.²

An alternative decision-making approach is called **deontology**. According to deontology, people innately owe certain duties to each other and should conform to this mandate, without regard to how their actions impact society. Deontology, in Greek, loosely means *do your duty*.

Example 3-1

A rational, elderly woman in agonizing pain is lying on her deathbed. Upon seeing her doctor, she pleads with him, "Please end my suffering by giving me a lethal injection." By law and by training, the doctor is not allowed to honor the patient's wishes. From a purely ethical perspective, what should the doctor do?

Solution

Under consequentialism, the doctor probably should honor the patient's request because consequentialism aims to achieve the end result that maximizes happiness or, equivalently, minimizes unhappiness.

In contrast, under deontology, a doctor has a fundamental duty to preserve life, without regard to the consequences. Thus, according to deontology, the doctor must decline the patient's request.

Consequentialism

In economics, a choice is worthwhile if its marginal revenues exceed its marginal costs. Accountants likewise use this approach in solving *net present value* problems. For instance, if a company determines that the present value of the cash inflows generated by a new machine will ex-

² Some instead call this approach teleology, which in Greek loosely means "look at the end result."

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ceed the related cash outflows, the company rationally should buy the machine.

Consequentialism applies a similar decision-making framework, with a twist. Consequentialism generally considers how the marginal benefits and costs of a decision affect *society* as a whole, rather than just the impact on a single company.

The most commonly applied form of consequentialism is called **utilitarianism**. Under a utilitarian framework, an act is ethical if, on balance, it improves the overall well-being, or *utility*, of all members of society. Two of the earliest proponents of utilitarianism, philosophers Jeremy Bentham and John Stuart Mill, stated centuries ago that the goal of utilitarianism was to achieve the *greatest good for the greatest number* of people. In economic terms, utilitarianism is a quantitative approach to ethics that aims to achieve positive net happiness for all stakeholders affected by an act.³ Throughout this chapter and most of this book, we will focus on utilitarianism because it is the most common form of consequentialism.

Example 3-2

If you pursue a certain course of action, four people will be made better off, and three people will be made worse off. Each of the seven people affected by your action will experience the identical gain, or loss, of pleasure.

Under utilitarianism, should you pursue this course of action?

Solution

Yes. Overall, your decision will generate a gain of four units of utility and a loss of three units. Thus, the consequence of your decision is a net gain of utility.

The Nature of Utilitarianism

The chief advantage of utilitarianism is that it is objective and measurable. The plusses and minuses of an act essentially are entered into an ethics calculator, and *voilà*, an answer emerges.

Also, utilitarianism guides us to contemplate the costs to society before making a decision. Thus, consequentialism forces decision makers to consider the potential adverse impact of an action on others, rather than consider just their own personal gain. The utility of all members of a

³ Consequentialism usually is focused on maximizing the welfare of society as a whole. However, it has other utility-maximizing forms, such as egoism (in which the goal is to maximize the well-being of the decision maker only) and altruism (in which the goal is to maximize the well-being of everyone besides the decision maker). Throughout the book, the term consequentialism will be used interchangeably with the notion of utilitarianism, unless the context indicates otherwise.

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community must be considered, without regard to their wealth, social status, race, or religion.

Although the concept of utilitarianism may sound daunting, it actually is a simple idea that is enshrined in popular culture. For instance, as Spock approaches his death in a *Star Trek* movie, he and Captain Kirk proclaim that Spock valiantly will have sacrificed his own life for others because “the needs of the many outweigh the needs of the few. . . .”

Criticisms of Utilitarianism

Despite its advantages, utilitarianism is subject to several important criticisms.

First, it is extremely difficult to gauge the degree of pleasure, or utility, that people derive from a decision. As a result, it can be challenging in practice to distill the pros and cons of a decision into a simple mathematics exercise.

To illustrate, consider the ethical dilemma that a tobacco company faces in deciding whether to advertise its cigarettes on a billboard located near an elementary school. How can the company quantify the financial benefits of this ad, compared to the potentially harmful health effects that children viewing the billboard incrementally might suffer from seeing this enticement to become cigarette smokers?

A second criticism is that consequentialist philosophies such as utilitarianism approach decisions from the standpoint of their *end* consequences, regardless of the *means* used.

Consider a married man who loves his wife deeply, but really wants to have an affair with another woman. He expects to derive great pleasure from a romantic encounter, and he is convinced that his seemingly perfect alibi will prevent his wife from getting hurt by discovering his infidelity. Is it acceptable for him to have an extramarital affair? To a utilitarian, the answer probably is yes. Net societal happiness probably will increase because this man’s expected utility is great, and his wife will experience little or no harm. Few, though, would ever contend that having an extramarital affair is an ethical act.

As another illustration, let’s examine the perennial question seen in many movie thrillers: Is it ethical to torture a terrorist if the information gained will save the lives of thousands? To a utilitarian, the answer once again is clear. If the societal benefit from saving thousands of lives exceeds the pain suffered by the terrorist, the terrorist should be tortured. The utilitarian view is that the *end justifies the means*, as long as we collectively are better off.

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This very scenario went from fiction to reality when Dzhokhar Tsarnaev was arrested for the 2013 Boston Marathon terrorist attack that wounded 200 people. In the aftermath of the bombing, the police feared that other bombs might be set to detonate. Notwithstanding these potentially imminent threats, law enforcement officials ended their interrogation and informed Tsarnaev of his right to remain silent. Reportedly, Tsarnaev stopped talking, potentially allowing fellow conspirators to flee and leaving innocent citizens at risk.

A third criticism of utilitarianism is that by only considering the overall benefit to society, decision makers willingly may sacrifice the rights of a few for the benefit of the majority. To illustrate, assume that a shift in the progressivity of income tax rates will give 10 poor people one unit of economic utility each, but will take 8 utility units from one rich person. A utilitarian would conclude that it is ethical for the tax authorities to confiscate more of the rich person's property because society generates a net gain of 2 utility units. Although protecting the rich rarely evokes great sympathy, protecting minorities from the tyranny of the majority is the hallmark of a just society.

Example 3-3

After a woman was violently assaulted, community police identified five men as suspects. These men are named A, B, C, D, and E. Suspects A, B, C, and D lead prosperous lives, have families, and are congenial individuals. Suspect E, in contrast, is a loner, has a physically intimidating appearance, and previously has spent time in prison due to assault convictions. He does not want to return to prison, but he says that going to prison is "not a big deal."

Suspect E did *not* commit this crime. However, the other suspects and all women in the community would be thrilled if Suspect E is convicted and imprisoned for this crime. Under utilitarianism, should the community convict Suspect E of a crime he did not commit?

Solution

Probably yes. If Suspect E is convicted, everyone in the community will gain utility, and Suspect E will suffer a small loss of utility. Thus, it appears that society's utility is maximized by having E go to prison, even though he did not commit any crime.

Finally, utilitarianism suggests that a decision should accomplish a net benefit to society. But what stakeholders comprise *society*? Should decision makers consider the impact on only those members of society who live in their geographic area? Or, should people who live in different cultures elsewhere in the world also be considered? When the U.S.

government enacted policies that encourage the production of ethanol from corn, this policy was heralded by some as a first step toward America achieving energy independence. However, this policy bid up the price of corn, which is a dietary mainstay of impoverished Latin Americans. As a result, if only United States stakeholders are considered, this policy arguably generated net positive utility. From a broader perspective, however, it was disastrous globally because it exacerbated the ravages of hunger around the world.

Deontology

The Nature of Deontology

Nobel Prize-winning author Luigi Pirandello once wrote that “each of us . . . is clothed with some sort of dignity, but we know only too well all the unspeakable things that go on in the heart.”⁴ Deontology echoes this view, asserting that we all have a moral duty to respect and treat one another with dignity.

The philosophical views of deontology were cogently expressed by philosopher Immanuel Kant. According to Kant, all people owe certain duties to others, which he calls **categorical imperatives**. Categorical imperatives are obligations that we must abide by at all times, irrespective of the surrounding circumstances.

As we have seen, consequentialists focus on the impact of an action, essentially using cost-benefit analysis. In contrast, deontology focuses on whether we have a moral duty to behave in a certain manner, *regardless* of societal impact. At its core, deontology focuses on the concept of *duty* to others, regardless of the consequences.

To illustrate this notion of duty, answer this simple question: Do you voluntarily leave a tip for a food server as you leave a restaurant, even if you do not plan to ever dine at that restaurant again? If so, you are acting out of a sense of duty because your action gains you no benefits whatsoever. Without even knowing it, your actions exemplify deontology.

Deontology is comprised of two elements, called the *universality principle* and the *reversibility principle*.

The Universality Principle

Deontology is based, in part, on the **universality principle**. According to the universality principle, certain duties and corresponding rights apply globally to all people, in all situations.

⁴ Luigi Pirandello, spoken by the father in the play *Six Characters in Search of an Author*, act 1 (New York: Dutton, 1921).

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Although the precise contours of Kant’s universality principle are uncertain, believers in deontology generally concur that the following fundamental duties, at minimum, merit universal acceptance: The duty to not cause physical harm, the duty to respect others’ privacy, the duty to respect others’ freedom of association, the duty to respect others’ property rights and agreements, the duty to treat equals equally, and the duty to tell the truth.

1. The Duty to Not Physically Harm Others

Deontologists believe that we all have a universal duty not to injure or kill others. As a stark example, Kant and his adherents considered torture to be universally wrong as a violation of human dignity. Thus, even if information gained from torturing a terrorist would save thousands of lives, believers in deontology would firmly reject acts of torture.

2. The Duty to Respect Others’ Privacy

You may not have the fame of Miley Cyrus or the charm of Johnny Depp, but you do have something that these celebrities profess to crave: Privacy. As one observer commented about privacy:

It seeks to erect an unbreachable wall of dignity and reserve against the entire world. The free man is the private man, the man who still keeps some of his thoughts and judgments entirely to himself, who feels no overriding compulsion to share everything of value with others, not even those he loves and trusts.⁵

Privacy has multiple facets, including the following:

- Privacy of body, such as the right to be free from airport whole-body searches, dressing room cameras, biometric security checks, and employer-mandated substance abuse testing
- Privacy of thought, such as freedom from employer-mandated lie detector tests
- Privacy of communication, such as freedom from intrusions into one’s emails and wireless phone calls
- Privacy of data, such as medical records, credit card purchases, tax returns, and security passwords
- Privacy of location, such as freedom from having our whereabouts monitored by GPS-based location devices or unmanned drone aircraft
- Privacy of solitude, which is the right to be left alone, free of unwanted intrusion

⁵ Clinton Rossiter, *Aspects of Liberty* (Ithaca, NY: Cornell University Press, 1988), quoted in Alan Westin, “Privacy in the Modern Democratic State,” in *Ethical Issues in the Use of Computers* (Belmont, CA: Wadsworth, 1985), p. 188.

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In the workplace, it is easy to understand why employers want to monitor their employees' conduct. However, employers would be well served to remember Doctor Seuss's tale about the imaginary town of Hawtch-Hawtch, where the main industry was a single bee that made honey. According to this fable, to get more honey, the citizens of Hawtch-Hawtch hired a Bee-Watcher because a "bee that is watched will work harder, you see." When the Bee-Watcher failed to make the bee work harder, the town hired a Bee-Watcher-Watcher to watch the Bee-Watcher. Alas, when that failed, they piled on even more Bee-Watcher-Watchers until the entire town was employed to spy on one another.⁶

As this bit of wisdom from Doctor Seuss illustrates, employers should consider whether intrusive surveillance cameras and computer monitoring technology unnecessarily, and perhaps counterproductively, interfere with employee privacy rights.

3. The Duty to Respect Others' Right of Free Association

We have a duty to respect others' right of free association. This encompasses the rights to participate in religious worship, political expression, and social activities without interference. The universality of the right of free association is confirmed by its inclusion in the United Nations' Universal Declaration of Human Rights.

4. The Duty to Honor Others' Property Rights and Agreements

By respecting private property and the enforceability of agreements, society gives people the confidence to trust that mutual promises will be honored. This in turn allows citizens to enter into mutually advantageous exchange transactions that improve their economic well-being.

In ancient times, business owners principally were concerned with agreements and property rights involving goats, sheep, land, and other physical property.

Modern businesses, in contrast, often are concerned with acts that interfere with intellectual property rights and other forms of intangible property. These concerns focus on the interception of confidential information, the misappropriation of trade secrets, the improper use of insider stock data, and identity theft.

Even ancient philosophers understood that ideas and words possess great value. For example, Roman philosopher Horace, born in 65 BC, prophetically foresaw the importance of protecting confidential emails

⁶ Doctor Seuss, *Did I Ever Tell You How Lucky You Are?* (New York: Random House, 1973).

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when he wrote that “once a word has been allowed to escape, it cannot be recalled . . . a word, once sent abroad, flies irrevocably.”⁷

5. The Duty to Treat Equals Equally, with Justice for All

Access to impartial justice is a fundamental right. Furthermore, if two similarly situated people commit crimes, their punishment should be identical, regardless of their social class, race, religion, national origin, or other group affiliation.

6. The Duty to Tell the Truth

Without knowing the truth, people cannot make informed choices about matters that affect their happiness.

Kant wrote extensively about the immorality of deception and lies. He even wrote about the importance of providing truthful information to lenders and other readers of financial statements:

A man finds himself forced by need to borrow money. He well knows that he will not be able to repay it, but he also sees that nothing will be loaned to him if he does not firmly promise to repay it at a certain time. He desires to make such a promise, but he has enough conscience to ask himself whether it is not improper and opposed to duty to relieve his distress in such a way.

Kant continued:

*. . . A [moral] law which says that anyone who believes himself to be in need could promise what he pleased with the intention of not fulfilling it would make the promise itself and the end to be accomplished by it impossible [because] no one would believe what was promised to him.*⁸

Remarkably, Kant expressed these views in 1785, but his timeless belief in truthful financial disclosures remains firmly entrenched in modern-day laws, such as the federal securities acts, Truth-in-Lending laws, the Dodd–Frank Act, and the Sarbanes–Oxley Act.

The Reversibility Principle

Kant believed that ethical behavior also should satisfy the **reversibility principle**. The reversibility principle essentially expresses the well-known Golden Rule of treating others as you would like them to treat you. It implores people to evaluate their behavior by mentally *reversing* their role from being the giver of an act to being the receiver, or vice versa.

⁷ Horace, “The First Book of the Epistles of Horace” in *The Works of Horace, Translated Literally into English Prose* by C. Smart, A. M. of Pembroke College, Cambridge (New York: Harper & Brothers, 1889).

⁸ Kant, “Foundations of the Metaphysics of Morals,” 1785.

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FIGURE 3-1 Core Philosophies

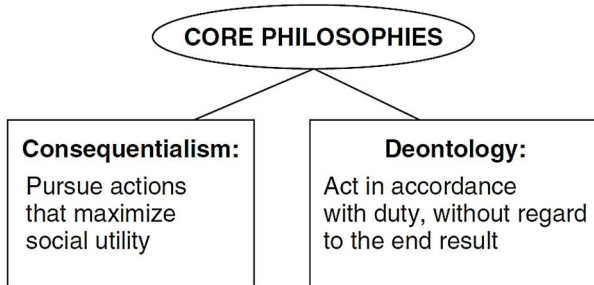
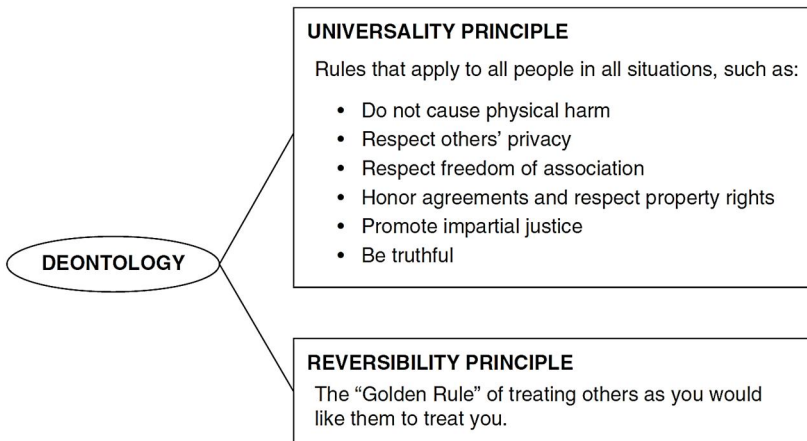


FIGURE 3-2 The Two Core Principles of Deontology



Example 3-4

When two roommates purchased a refrigerator and a dishwasher from a retail store, they financed their purchase on credit. The agreement stated that the store had the right to repossess “every item ever purchased from it on credit, if Buyer fails to make a single payment on time.” When the customers hesitated to sign such an onerous agreement, the store manager assured them that they should “go ahead and sign . . . we never enforce that part.”

Thereafter, these roommates made every payment in full, on time. However, the store’s bookkeeping system incorrectly failed to credit their payments properly, so their account erroneously was marked as *Past Due*.

Believing that these customers were in default, the store manager told an employee to “go repo everything those gay dudes ever got from us.” While attempting to repossess these roommates’ property at 2 a.m., the store employee broke the lock on their apartment and pushed the customers on the floor, causing them to bleed profusely.

What ethical duties did the store violate?

Solution

Six duties were violated.

The store employee should not have physically harmed these customers or violated their privacy by entering their residence without permission.

The manager's superfluous reference to the customers as "gay dudes" suggests that he disrespects their right of free association and does not believe in treating all customers equally, irrespective of their sexual preference.

Finally, the store manager violated the customers' property rights because the customers had not breached their purchase agreement, and he lied about never enforcing the repossession provision in the purchase agreement.

Criticisms of Deontology

Some contend that the deontological approach to ethics suffers from several shortcomings.

First, deontology's core mandate that people should "respect human dignity" is too abstract and difficult to visualize. Rock artist Bob Dylan's song "Dignity" highlights the elusive and amorphous nature of dignity: "Someone showed me a picture and I just laughed . . . dignity's never been photographed."⁹

Consider this quandary: A U.S. company wants to establish a foreign manufacturing plant that will provide jobs to unskilled workers in an underdeveloped country with massive unemployment. Due to competitive market conditions, the company can hire 1,000 workers at poverty-level wages, or it can afford to hire 750 workers at above-market wages. If the company pays poverty-level wages to 1,000 workers, it expects its low-wage policy to be criticized for "failing to respect human dignity." In contrast, if the company hires 750 workers at above-market wages, it will avoid criticism, but it in effect will have condemned 250 residents to despair and possible starvation. Which of these two alternatives better fosters human dignity?

Second, deontology does not provide any guidance for resolving situations in which opposing moral duties are at issue. For example, a controversy recently arose when wedding chapel owners in Idaho publicly refused to perform gay marriages as a matter of religious conscience. Should they feel compelled to provide services to all customers? Deontology favors both freedom of religion and equal treatment for all, which leaves these wedding chapel owners without a solution to their predicament.

As a more dramatic example, consider the dilemma posed in the movie *Sophie's Choice*. Early in the movie, Sophie's captors in prison

⁹ Bob Dylan, in the song "Dignity," 1991.

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tell her that they plan to kill both of her imprisoned children. However, the captors agree to kill only one of her children as long as Sophie selects which one will die. A believer in consequentialism would unhesitatingly instruct Sophie to select one of her children for death, so she can at least preserve the other child's life. Deontology's mandate against harming others, on the other hand, leaves Sophie without any guidance for resolving this heart-wrenching dilemma.

Agonizing moral choices are not only the product of Hollywood fiction; they arise in business as well. In 1978, for example, paint manufacturer American Cyanamid became concerned that a hazardous substance used in its production processes might cause severe birth defects in unborn fetuses. As a result, the company removed women of child-bearing age and capability from performing certain factory jobs, some of which were highly paid positions.¹⁰

How should American Cyanamid have balanced an unborn fetus's right to a healthy life against a female employee's right to pursue her chosen career? Both the right of a fetus to good health and female employees' right to a full panoply of job opportunities involve fundamental issues of human dignity. Once again, deontology fails to provide a clear calculus for weighing conflicting considerations.

FIGURE 3-3

The Sensitive Superhero

Fans of superhero fiction have often wondered why Batman doesn't just kill his nemesis, the evil Joker. The Joker has dared Batman to kill the "postulant pestilence that is me" many times. If the Caped Crusader were to simply eliminate this villain, only the ever-so-sinister Joker's life would be lost, but the lives of thousands of terrified citizens of Gotham would be saved. Batman's response is a direct one: "I don't want to become that which I hate"—a person who dishonors the dignity of life.

Batman's unwillingness to take one life to save many clearly demonstrates why Batman is called the Caped Crusader, not the Caped Consequentialist. By refusing to physically harm the Joker out of respect for human dignity, Batman personifies the deontological perspective on life.

Holy Deontology, Batman!

¹⁰ To keep their well-paid jobs, four female employees claimed that they had a doctor sterilize them surgically.

Example 3-5

Donald Sterling, owner of the Los Angeles Clippers professional basketball team, made racist remarks against black Americans in a private telephone call that was illegally recorded by a female companion. To humiliate Mr. Sterling, the companion released this audiotape to the media, which in turn broadcasted it to the general public. Was it ethical for the media to broadcast this audio recording?

Solution

Deontology does not provide a clear answer. According to deontology, it is a categorical imperative that equals should be treated equally. Mr. Sterling's statements disparaged black Americans and implied that they were undeserving of the same rights and fair treatment that other Americans receive. As a result, Mr. Sterling deservedly was criticized and ostracized.

On the other hand, both the law and sound social policies concerning privacy gave Mr. Sterling the right to freely express his thoughts without fear of retribution. Deontology considers the right of privacy to be a fundamental right.

In sum, the right to equal treatment without regard to race clashed in this case with the right of privacy. Deontology does not provide a mechanism for resolving situations in which competing rights are in conflict.

Revisiting Core Ethical Principles

Is Lying Ever Ethical?

If you think back to the first time a parent punished you, it probably was for telling a lie. Yet, ironically, many parents themselves are deceitful when they tell their children that the Tooth Fairy puts money under their pillow, Santa Claus descends through the chimney, or their ill-fitting prom dress makes them “look prettier than a princess.”

To Kant and other deontology adherents, telling the truth is an inviolable, moral imperative because speaking untruths “annihilates dignity” and prevents the listener from making rational, informed choices. In contrast, utilitarians, such as Mill, believe that lying is ethically permissible if it is socially beneficial. As an illustration, assume that you are confronted by a known murderer who demands to know the location of your friend, his next intended victim. To save your friend, a utilitarian would unhesitatingly approve of you lying about his whereabouts.

According to Wharton Professor Maurice Schweitzer, lies are unethical when the speaker selfishly gains an undeserved benefit or wrongly harms the listener.¹¹ However, lies are ethical when they are benevolent,

¹¹ Emma E. Levine and Maurice E. Schweitzer, “Are Liars Ethical? On the Tension between Benevolence and Honesty,” *Journal of Experimental Social Psychology* 53 (2014): 107–117.

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socially desirable acts of kindness. For example, when we compliment grandma on her cooking, but secretly feed her unappetizing meal to the family dog, our *white lie* promotes family unity and minimizes harm. Similarly, when a work supervisor accentuates an employer's potential for improvement and is less than frank with her criticisms, her statements have the desirable effects of fostering trust, inspiring confidence, and encouraging perseverance.

In contrast, the utterance of harsh truths can be destructive and arguably unethical. For instance, when young Steve Jobs first shared with his mother his vision of creating personal computers, she forthrightly ridiculed the idea, asking, "Why would anyone ever want to have a computer in their house?" Although Mrs. Jobs surely considered her criticism to be both truthful and constructive, the world would be a very different place if her harsh honesty had dissuaded her son from starting the company Apple. As a classic rock tune says, "To the heart and mind, ignorance is kind; there's no comfort in the truth, pain is all you'll find."¹²

Other acts of deceit are ethical because they are harmless. Have you ever cheered for the misdirection of a *fake* hand-off in football, or bluffed to win in a friendly game of poker? Those are intentional misrepresentations because they are morally neutral. Similarly, now that the *Big 10* athletic conference has 14 teams and the band *Maroon 5* has six members, even the very names of these groups are falsehoods. Once again, though, these lies are harmless and ethically acceptable. Now, let's consider the tougher, and more important, question of whether lying in negotiations and professional activities is ever acceptable.

One controversial viewpoint is that lying is acceptable as long as "such deception can resemble a game where both partners know the rules."¹³ In diplomacy, for instance, a country's head of state invariably will respond to a threatened enemy attack by declaring that his country will "fight to the end," even if in reality it lacks the weapons or the desire to do so.

In the courtroom as well, few people are surprised when the lawyer for a criminal defendant pleads *Not Guilty* in the face of overwhelming evidence to the contrary. In short, in some situations, lying is merely a game strategy of sorts, not a moral sin. As British statesman Henry Taylor once expressed this view, "Falsehood ceases to be falsehood when it is understood on all sides that truth is not expected to be spoken."¹⁴

¹² "Careless Whisper," performed by George Michael.

¹³ Sissela Bok, *Lying: Moral Choice in Public and Private Life* (New York: Pantheon, 1978).

¹⁴ Quoted in Albert Carr, "Is Business Bluffing Ethical?" *Harvard Business Review* 46 (Jan.–Feb. 1968): 143–153.

FIGURE 3-4

<u>When Lying Generally Is Acceptable</u>	
Flattery:	“Wow, you look especially awesome today!”
Social courtesies:	“It was really great to meet you.”
Gratitude:	“Thanks for the wonderful birthday present.”
Fantasy:	“So the princess kissed the frog and it became a handsome prince.”
Joking:	“A three-legged leprechaun and a parrot walked into a bar...”
Bargaining:	“That’s my final offer.”
Easing discomfort:	“Yes, as your devoted friend, I am concerned about this serious illness, but I am confident that you will live a long time.”
Compulsory replies:	“Yes, I would love to work for your firm if you give me a job offer; your firm definitely is my first choice.”

FIGURE 3-5

<u>Spotting Online Liars¹⁵</u>	
According to a study of Internet dating sites, liars tend to:	
▪	Write shorter profiles
▪	Write using “not” phrases. For example, honest people might describe something fun as “good,” but liars would describe it as “not bad”
▪	Write with sentence fragments rather than full sentences

An implicit understanding that “truth is not expected to be spoken” apparently exists in the world of online dating, which seemingly is populated with hard drives full of liars. According to one study, approximately 80% of all online daters lie in their profiles about their height, weight, or age. An author of the study, sociologist Catalina Toma, claims that little harm results because, anticipating that online dating profiles will contain exaggerations, online participants commensurately discount others’ veracity. She characterizes online daters as merely making promises that they “roughly resemble” who they truly are.¹⁶ In short, some might say that minor untruths in Internet social interactions are accepted elements of *Netiquette*.

Lying also occurs regularly in the sale of merchandise, especially in local economies populated with small businesses. Some sugarcoat these

¹⁵ Hancock, et al., “The Truth about Lying in Online Dating Profiles,” 2007.

¹⁶ Hancock and Toma, “The Truth about Lying in Online Dating,” CHI 2007 Proceedings.

interactions with words like *negotiations* or *haggling*, but in actuality they just are plain lies. Street vendors in Latin America, for instance, regularly insist that they are offering their *final and best price*, but then shamelessly lower their price moments later as a noncommittal customer starts to walk away. Some consider these deliberate misstatements to be unethical, but others judge them to be well-understood, ethically acceptable elements of certain social interactions.

Example 3-6

While at a nightclub, a well-dressed guy told a female patron that she was the “most charming woman in the world and definitely the kind worth marrying.” The two had just met for the first time that evening.

This guy had told three other women the same thing earlier in the evening. Were his statements unethical?

Solution

Probably not. Kant and followers of deontology considers all lies to be unethical. However, most people implicitly do not expect *pick-up* lines uttered at a nightclub to be truthful, and they discount such comments accordingly.

Is Stealing Ever Ethical?

When Stealing Occurs

When police asked captured bank robber Willie Sutton, “Why do you rob banks?” he reputedly answered, “Because that’s where the money is.” Although criminal masterminds of the past may well have focused on robbing banks, in the modern economy, stealing generally is far less visible and far more high-tech. According to the FBI, identity theft annually accounts for nearly 1,000 times more in losses than bank robberies and bank hackers have been known to siphon off millions of dollars without ever walking into a financial institution.¹⁷

The traditional definition of stealing is the taking of others’ property without their consent. Viewed through a more modern definitional prism, stealing occurs when one person takes another’s rights, freedoms, or wealth without their consent. Are you a thief if, despite being able to afford health insurance, you do not buy it and later go to a hospital emergency room but cannot pay? Yes, because you have taken the services of the physician and hospital that treated you. Moreover, are you a thief if you go to class with a contagious cough, knowing that you are likely to infect a fellow classmate? Although self-denial may prevent you from

¹⁷ FBI Crime Statistics, 2010. Nowadays, bank robbers net a mere \$5,000 per attempt.

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acknowledging it, you have indeed stolen your classmate's right to enjoy illness-free days.

The digital world has expanded the opportunities for theft. Stealing occurs, for example, when you download copyrighted music or a pirated movie and do not compensate the creators for their efforts. You may not realize it, but digital piracy steals from fellow music fans as well as artists because it degrades the economic incentives for artists to create the works of entertainment and technology that delight us all.

Stealing even occurs when you give your business a name that sounds remarkably similar to another well-known enterprise. A few years ago, for example, a pornographic website operated using the web address *ucla.com*. Imagine how surprised college applicants to UCLA were when they inadvertently searched for that domain name instead of the correct web address, *ucla.edu*. Officials at UCLA were not amused, and they forced this deceptively similar site to shut down immediately.

Example 3-7

An enterprising recent college graduate named Joe MacDonald recently started a hamburger restaurant. Because his last name is so closely associated with hamburgers, he named his own restaurant *MacDonald's* and painted the exterior red and yellow. His name is spelled slightly differently from the *McDonald's* restaurant chain, and his menu does not include French fries. Were Joe's actions ethical?

Solution

No. The name *McDonald's* and the exterior colors of its stores are so well known that it is clear that Joe intended to steal the well-known restaurant's customers. Under federal trademark laws, Joe's actions also were unlawful because they created "confusion as to the source" of his food items.

Is It Ever Acceptable to Take Others' Property?

Every society must strike a delicate balance between protecting the rights of inventors and artists and allowing society to enjoy the benefits of their creativity. In the United States, patent and copyright rules generally embrace the moral view that creators of intellectual property ought to retain the exclusive right to profit from their efforts, at least for an extended period of time. This is consistent with deontology's view that property and contract rights must be respected. Thus, posting a copyrighted video on *YouTube* or sharing a password to single-user software is both unethical and illegal.

FIGURE 3-6

Does Photographing Someone “Steal” Their Image?

You generally *may* “take” a photograph of another person without their permission, unless:

- They are in a place where they have a reasonable expectation of privacy, such as a public bathroom or their home
- You display their photograph for commercial purposes, such as in an advertisement

However, in some cases, society has adopted a utilitarian view that permits artistic creations to be used without compensation when the benefit to society exceeds the utility loss to the creator. This rule, called the *fair use doctrine*, allows educators to use portions of a copyrighted work for educational purposes, and it allows a person to *take* another’s creative work to critique or parody it. As an illustration, the pioneering rap group 2 Live Crew created a parody of the well-known ballad *Pretty Woman* that it re-titled *Hairy Woman*. When the song’s composer challenged these performers in court, the U.S. Supreme Court upheld the rappers’ free speech right to incorporate elements of the original song into their version.¹⁸

Is Discrimination Ever Acceptable?

The word *discrimination* evokes painful memories of a shameful era in American history when blacks and other minorities were denied equal treatment under the law. Over time, the most pernicious forms of discrimination based on race, color, religion, sex, or national origin have been rejected by most Western societies. However, there is no societal consensus against certain forms of discrimination.

For instance, federal age discrimination rules do not protect people who are under age 40. Thus, an employer generally is free to hire a 22-year-old worker over a 38-year-old worker purely based on their age.¹⁹ In many states, discrimination based on sexual orientation also remains permissible, although the trend is toward banning this form of discrimination.

The tax law also seemingly condones certain forms of discrimination, such as discrimination based on marital status. Consider two single individuals who each earn identical \$150,000 incomes per year. The moment that they get married, their combined gross income doubles to

¹⁸ *Campbell v. Acuff-Rose Music*, 510 U.S. 569 (1994).

¹⁹ <http://www.eeoc.gov/laws/types/age.cfm>.

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\$300,000,²⁰ but their tax burden *more than doubles* under our progressive tax system. Congress may not explicitly have intended to discriminate against people who get married, but the so-called *marriage penalty* is a predictable by-product of our tax regimen. Consequently, before proposing marriage, a suitor is well advised to get down on one knee with a ring in one hand and a calculator in the other.

Discrimination against certain classes of consumers also remains permissible. Indeed, many marketing classes explicitly teach students to separate customers into market segments to commit **price discrimination**. Do you feel a bit envious when your ever-so-wrinkled former professor gets a *Senior Citizen* discount and you have to pay full price? Or bothered when your cover charge to a club is waived on *Ladies' Night*, but your male buddies pay full fare? Are these acts of offensive age and gender discrimination, or just sound decisions by savvy business owners?

The cyberworld has allowed sellers to create price discrimination techniques that are increasingly sophisticated and imperceptible. Were you aware that Sunday typically is the cheapest day of the week to buy airplane tickets online because vendors know that corporate customers with generous expense accounts usually don't shop for travel during weekends?²¹ Or were you aware that one online travel site sold identical hotel rooms to Apple users at higher prices than it charged other users, in the belief that Apple users were more affluent and less price sensitive?²² All these techniques are legal, even though they are dubious from ethical and public relations perspectives.

Of course, some forms of price discrimination clearly are cost justified, at least statistically speaking. Young males cause more auto accidents than young females, inexperienced drivers cause more accidents than experienced ones, and brash drivers of new Lamborghinis have a remarkable penchant for converting them into smashed-up Lamborghinis.

Example 3-8

A U.S. shipping company charges \$5 per cubic foot to ship goods from China to the port of Long Beach, California, but charges only \$2 per cubic foot to ship goods from Long Beach to China. Is this discrimination ethical?

²⁰ Deduction phase-out rules and passive activity loss phase-out rules may cause a married couple's combined taxable income to be greater than the sum of what each spouse's income would have been had each remained single.

²¹ "The Best Day to Buy Tickets," *The Wall Street Journal*, October 23, 2014.

²² "Can You Trust That Web Price?" *The Wall Street Journal*, October 23, 2014.

Solution

Yes. The United States imports more goods from China than China imports from the United States. As a result, the demand for shipping space is far greater on trips from China to the United States than on the return trip to China. Shipping companies are simply pricing according to market demand, despite incurring identical costs of operation in both directions.

Neurobiology and Ethical Decisions

In a college graduation speech, Apple CEO Steve Jobs implored students to “have the courage to follow your heart and intuition.”²³ But do people make moral judgments by instinctively following their heart and intuition? Or do they engage in deliberative, rational analysis, similar to the models explored in the preceding chapter?

According to neuroscientists using brain scans, both the emotion-centered regions of our brains and the analytically focused regions sometimes display neural activity when we confront moral dilemmas.²⁴ Thus, some neuroscientists contend that, in approaching moral decisions, *dual processing* often occurs in which the *emotional* and the *analytical* regions of our brains compete with each other to dominate our decisions. Our emotional brain center is often referred to as *System 1*, and the analytical brain center is called *System 2*. The degree of response observed in each of these two brain regions depends on the nature of the moral judgment at issue.

A Self-Test

To illustrate these decision-making processes, consider the following situation:

A pharmacist invented and manufactured a spray-on skin cream that instantly kills a specific virus. He spent millions of dollars on research and development to invent this ointment, and he now produces it at a marginal cost of less than one dollar. He now is contemplating selling the patent rights to this ointment to a Canadian drug manufacturer. Financial analysts all agree that the Canadian drug manufacturer's high bid to acquire the patent rights reflects its intent to triple the price of the ointment. Is the pharmacist's decision to sell the patent rights ethical?

²³ Steve Jobs, Stanford University Commencement address, June 12, 2005.

²⁴ Emotions tend to activate the amygdala and ventromedial prefrontal cortex regions of the brain, whereas rational reasoning tends to activate the anterior dorsolateral prefrontal cortex region of the brain.

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Please formulate your answer to the preceding question. Then, consider a second, distinct situation:

A pharmacist manufactures a spray-on skin cream that instantly kills an excruciatingly painful, flesh-eating virus. He spent millions of dollars on research and development to invent this ointment, and he now produces this ointment at a marginal cost of less than one dollar. He intends to triple the \$50 price of this ointment. By doing so, at least 7,000 poor patients will no longer be able to afford this ointment and will suffer crippling pain. Is his decision to raise the price ethical?

For many readers, the first scenario merely involves a common business decision and does not evoke an emotional response. As a result, many readers will solve the question presented using *System 2* cognitive brain regions that analyze business data, such as low marginal costs and the free-market right to earn a profit.

The second situation, in contrast, activates a response in emotion-driven brain regions, *System 1*, because phrases like *flesh-eating*, *poor*, and *crippling pain* make this decision more emotionally evocative.

Not surprisingly, many respondents conclude that the pharmacist's decision to sell the patent rights in the first scenario is ethical. Rationally, he showed initiative and talent in developing his invention, and he should reap the benefits of his efforts.

However, some of these same respondents consider the pharmacist's decision to directly raise the price of the ointment to be unethical because of the emotion-laden aspects of such an action, even though both scenarios inflict a similar financial hardship on patients.²⁵

The Neuroscience of Deontology and Consequentialism

According to neuroscientists, deontologists' views about respecting human dignity tend to evoke more reflexive, effortless, automatic emotional responses. In contrast, consequentialism's weighing of benefits against costs tends to require a more time-consuming, cognitive analysis. In support of this conclusion, scientists have discovered that medical patients who have sustained damage to emotion-activated brain regions reach utilitarian moral judgments much more frequently than comparable healthy individuals do.²⁶

Let's compare two situations. First:

²⁵ Because these two scenarios were presented to you in sequence, you were more likely to see the similarity between them and construct your answers to both scenarios to be internally consistent. When only one of these dilemmas is presented to each of two groups, larger "between-group" differences in responses are observed.

²⁶ Koenigs et al., "Damage to the Prefrontal Cortex Increases Utilitarian Moral Judgments," <http://www.ncbi.nlm.nih.gov/pmc/articles/PMC2244801/>.

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An unmarried woman has been pregnant for nine months, but has hidden her pregnancy from others by wearing baggy clothing. Yesterday, she gave birth to a baby in an alley behind her high school and threw the newborn baby in a trash dumpster shortly before the garbage truck arrived to empty the dumpster. Was her decision ethical?

Now, after you have reached a conclusion about the preceding dilemma, formulate your answer to the following situation:

During wartime, you and your family are hiding in the darkened basement of your house as enemy soldiers approach. You do not want to alert the soldiers to your whereabouts. Accordingly, when your newborn baby begins to cry, you forcefully cover its mouth to dampen the sound. If you remove your hand, the soldiers, upon hearing the baby's loud crying, will locate and kill all of you. Alternatively, if you do not remove your hand, your baby will cease breathing from a lack of oxygen. Is it ethical for you to smother your baby to death by keeping your hand on the baby's mouth?

For most readers, the first decision is intuitive and quickly resolved. The emotion-driven, *deontology-oriented* brain region rapidly is able to conclude that killing the baby is immoral.

Resolving the second situation is more challenging and time consuming. Our emotion-activated brain regions tell us to never kill our own baby under any circumstance, but our *utilitarian-oriented* brain regions tell us to weigh competing considerations. If the parent keeps a hand over the baby's mouth, the baby dies, but the remainder of the family survives. Alternatively, if the parent does nothing to cover the baby's mouth, the baby, along with the entire family, will die. Thus, after deliberately balancing competing considerations, the disheartening but ethical choice under utilitarianism is to smother the baby.

Intriguingly, psychologists also have found that multilingual people are more likely to give a deontological response after reading an ethical dilemma in their native language, but are more likely to give utilitarian responses after reading ethical dilemmas in a secondary foreign language. These researchers surmise that reading a moral dilemma in a native language triggers a person's "intuitive, 'automatic' responses prompted by the emotional content of a given dilemma." Reading in a less familiar language, in contrast, requires more "rational, effortful, controlled processes driven by the conscious evaluation of the potential outcomes."²⁷

In summary, researchers are only starting to understand the complex brain processes that underlie ethical decision making. It appears that

²⁷ "Your Morals Depend on Language," Costa et al., www.plosone.org, April 2014, Volume 9.

ethicists' traditional focus on rational decision models was excessive. Instead, many ethical decisions appear to result from automatic *gut feelings*. Decision makers sometimes then rationalize these instantaneous reactions after the fact through the use of deliberative analysis.²⁸

Solution to “Am I Ethical?”

[B]

A company does not have a duty of disclosure to its employees, but the securities laws generally do impose a duty on publicly traded companies to disclose all material information to the investing public. Reports about CEO Jobs' health clearly influenced Apple's stock price and were material to the investing public.

On the other hand, respect for others' privacy is a fundamental ethical precept. Accordingly, under ordinary circumstances, Jobs' health condition was a private, personal matter that should remain confidential.

The company faced a difficult dilemma in deciding whether the investing public's right to know took precedence over Jobs' right of privacy. Society's ethical rules and laws do not provide clear guidance on how these two duties should be balanced.

However, this situation poses a different, simpler question: Was it appropriate for Apple to disseminate false information? Apple clearly misled the public and distorted the truth. As a result, Apple violated its ethical duty by making statements that it knew, or should have known, were untruthful.

A former director of Apple has stated publicly that he was “disgusted” by the company's conduct. Nonetheless, the SEC never initiated any disciplinary actions against Apple.

²⁸ Jonathon Haidt, “The Emotional Dog and Its Rational Tail: A Social Intuitionist Approach to Moral Judgment,” *Psychological Review* 108, no. 4 (2001): 814–834.

Review Questions

1. What decision-making approach focuses on the moral duty to behave in a certain manner, regardless of societal impact?
 - A. Deontology
 - B. Utilitarianism
 - C. Cost-benefit analysis
 - D. Consequentialism

2. What is an example of the reversibility principle?
 - A. Be truthful
 - B. Treat others as you would have them treat you
 - C. Respect others' privacy
 - D. Honor agreements

3. According to some neuroscientists, what occurs when one approaches normal decisions?
 - A. Discrimination
 - B. Cognitive analysis
 - C. Rational analysis
 - D. Dual processing

Review Answers

1.
 - A. **Correct.** Deontology focuses on whether individuals have a moral duty to behave in a certain manner, regardless of societal impact.
 - B. **Incorrect.** Utilitarianism is not a decision-making approach that focuses on the moral duty to behave in a certain manner, regardless of societal impact. Under a utilitarianism framework, an act is ethical if it improves the overall well-being of all members of society.
 - C. **Incorrect.** Cost-benefit analysis is not a decision-making approach that focuses on the moral duty to behave in a certain manner, regardless of societal impact. Consequentialists focus on the cost-benefit analysis of an action and its effect on the overall society.
 - D. **Incorrect.** Consequentialism is not a decision-making approach that focuses on the moral duty to behave in a certain manner, regardless of societal impact. Consequentialism generally considers how the marginal benefit and costs of a decision affect society as a whole.

2.
 - A. **Incorrect.** Being truthful is not an example of the reversibility principle. Under the universality principle, being truthful is an example of a rule that applies to all people in all situations.
 - B. **Correct.** The reversibility principle includes the “golden rule” of treating others as you would like them to treat you.
 - C. **Incorrect.** Respecting others’ privacy is not an example of the reversibility principle. Under the universality principle, respecting others’ privacy is an example of a rule that applies to all people in all situations.
 - D. **Incorrect.** Honoring commitments is not an example of the reversibility principle. Under the universality principle, honoring commitments is an example of a rule that applies to all people in all situations.

3.
 - A. **Incorrect.** Discrimination is not what neuroscientists believe occurs when one approaches moral decisions. Although the most pernicious forms of discrimination have been rejected by most Western societies, discrimination against certain classes of consumers remains permissible.
 - B. **Incorrect.** Cognitive analysis is not what neuroscientists contend occurs when one approaches moral decisions. Consequentialists

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weigh the benefits against costs of a decision and require more time-consuming, cognitive analysis.

- C. Incorrect. Rational analysis is not what neuroscientists believe occurs when one approaches moral decisions. The process of making ethical decisions can involve a deliberate, rational process.
- D. **Correct.** Some neuroscientists contend that, in approaching moral decisions, dual processing occurs in which the emotional and the analytical regions of the brain compete.

Chapter 4

Virtue, Justice, and Social Responsibility

Learning Objectives

- Identify the philosophy which focuses on training that helps prepare a person for the eventuality of making ethically correct decisions
- Select the philosophy or theory that supports the stakeholder theory
- Spot the definition of CSR which is rejected by most commentators because it requires mere compliance by all citizens as a minimum standard

Am I Ethical?

Edith and Thea were a legally married, same-sex couple. When Thea died, she left all of her property to Edith, who claimed that the entire transfer was not subject to estate tax. The IRS acknowledged that mere shifts of assets between spouses upon death are not subject to the estate tax. However, the IRS asserted that this estate tax exemption only applies to transfers between opposite-sex spouses.

Was the IRS's decision ethical?

- a. Yes, because only opposite-sex couples were contemplated by the law at the time that the estate tax was enacted
- b. Yes, because the IRS has the moral duty to ensure that sufficient tax revenues are available to sustain the provision of public services
- c. No, because similarly situated individuals should be treated equally
- d. No, because imposing taxes at death is inconsistent with deontology

The **solution** is revealed at the end of the chapter.

Introduction

Like many rural towns, Coudersport, Pennsylvania, owed its prosperity to one family. Tucked among the rolling northern hills of Appalachia, Coudersport had cable company Adelphia Communications at its epicenter and town patriarch John Rigas as its protector. Rigas was an affable sort who, along with two of his sons, built Adelphia into the sixth-largest cable company in America. Starting from humble roots, Rigas seemingly

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was everyone's best friend in this tiny town of 2,600 residents. If you needed a loan, a job, or a donation to a local charity, Rigas and the company were always ready with a helping hand. Adelfia, which means *brother* in Greek, epitomized corporate social responsibility, figuratively serving as every resident's compassionate sibling in times of need. All of this changed, though, as this publicly traded company piled on unsustainable debt levels. Rigas and his sons started using a company jet as a family taxi for whirlwind shopping trips, and they raided the company bank account as if it was their private piggy bank.

As the Rigas family's acts of social responsibility transformed into reckless irresponsibility, the company's auditors and bankers tacitly acquiesced. Eventually, though, the family's misdeeds caused Adelfia to disintegrate into bankruptcy, and Coudersport crumbled alongside it. This town of brotherhood had lost its soul to the unscrupulous acts of a dysfunctional family and the financial professionals who idly failed to stop them.

This chapter will extend our previous discussion of ethical theories by focusing on philosophies of justice, virtue ethics, egoism, and social responsibility.

Distributive Justice

The Nature of Justice

Imagine that you are in charge of giving away a truckload of perishable food to residents of a small famine-struck village. Would you give every resident the same amount? Or, would you divide the food based on some other measure, such as a person's age, weight, health, gender, or social status? **Distributive justice** focuses on how individuals should share society's resources and burdens.¹

Theories of Distributive Justice

The two most prominent philosophies of distributive justice were espoused by Aristotle and modern-day philosopher Thomas Rawls.

Aristotle's Theory of Distributive Justice

The core proposition of **Aristotle's theory of distributive justice** is straightforward: *Equals should be treated equally.*² This ethical precept,

¹ Distributive justice can be contrasted with *procedural justice*, which focuses on due process, and *retributive justice*, which focuses on the fairness of punishment imposed on wrongdoers.

² Aristotle, *Nicomachean Ethics*.

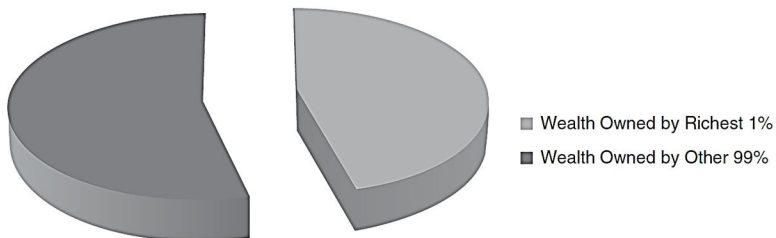
first set forth over 20 centuries ago, has the advantages of simplicity and universal acceptance.

Despite the straightforward nature of Aristotle’s view, it is often challenging to apply its core principle to real-world situations. Consider, for example, a company in which each of its two division managers earned exactly a 12.7% return on assets. One manager achieved this return by investing in risky projects, and the other only invested in low-risk projects. Are both managers *equals* who should receive the same year-end bonus? Or, was the second manager superior because she also benefited the company by minimizing its risks?

Aristotle’s theory of distributive justice also established a corollary principle: *Unequals shall be treated unequally*, with the magnitude of their differential treatment proportionately reflecting the degree to which they are unequal. Simply stated, if one employee is 20% less productive than others, his employer should pay him 20% less.

Applying this principle, in practice, can be challenging. For example, under the tax law, a divorced parent who files a Head of Household tax return receives preferential treatment over a childless person who files as a Single taxpayer. However, quantifying the degree to which heads of household and single individuals merit disparate treatment is, at best, highly subjective.

FIGURE 4-1 How Wealthy Are the Richest 1% of People in the World?³



Example 4-1

A large nonprofit organization expects its top two executives to retire at age 75. These two dedicated executives have each worked for the organization for fifty years and earn identical salaries. One is female, and the other is male.

According to independent pension consultants, the female executive has an actuarial life expectancy of 12 years, and the male executive has a life expectancy of only 6 years. As the organization’s accountant, you have been asked if, after making appropriate present value adjustments, the organization

³ <http://www.cnbc.com/id/101348398#>.

should pay the male executive about twice as much per year in pension benefits as it pays the female executive. By doing so, the *total* pension benefits received by both executives over their expected remaining lives will be identical. In accordance with Aristotle’s theory of distributive justice, what do you recommend?

Solution

Although these two executives are *equals*, reasonable people can disagree about what constitutes equal treatment. From one perspective, equal treatment means that each executive should receive the same *total* amount of pension benefits. According to this view, the male executive should receive a substantially higher annual payment than the female executive receives because his life expectancy is much shorter.⁴

However, from another perspective, equal treatment simply means that these two executives each collect the same annual pension benefit, even if their long-run total benefits likely will be quite unequal. According to this view, equal treatment does not require an organization to take into account gender-based actuarial differences.

Rawls’s Theory of Social Justice

The Core Approach

Imagine that you and several strangers have decided to play a card game with a special twist. Rather than set the card game’s rules ahead of time, all participants have agreed to set the rules of the game only after all players have reviewed the cards dealt to them. Naturally, subsequent to reviewing the dealt cards, one player might suggest a high point assignment for, say, aces and spades, but others might suggest a different scoring system. After failing to reach a consensus, the players naturally will conclude that the fair approach is to establish the rules of the game before any cards have been dealt.

Thomas Rawls was a 20th-century philosopher who essentially took the lesson learned from this imaginary card game and applied it to create **Rawls’s Theory of Social Justice**. This philosophy of distributive justice rests on two core observations.

First, Rawls recognized that we all enter this world with various advantages and disadvantages. Some of us are born with extraordinary talents and abilities; others are not especially gifted. We also differ in myriad other ways, such as by gender, ethnicity, physical capabilities, and family social class. To continue the card game analogy, we all are dealt different sets of cards.

⁴ All these amounts also need to be adjusted for time value of money differences.

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Second, Rawls recognized that the characteristics bestowed on us at birth invariably affect our attitudes and concepts of justice. For example, people who are born with physical limitations are more likely to favor societal policies that accommodate their disabilities. Similarly, people whose talents allow them to generate high incomes tend to favor lower taxes and smaller government, whereas those less fortunate tend to favor expansive government programs and greater wealth redistribution.

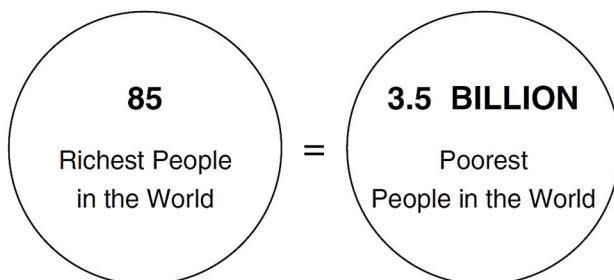
To achieve a just society, Rawls reasoned, we must establish societal principles that are not biased by the endowments with which, in hindsight, we fortuitously have been blessed or cursed. Rather, we should allocate society's resources *as if* we had made a binding pact *prior* to knowing our eventual status in life. Rawls calls this agreement a *hypothetical social contract*. Moreover, he coined the phrase **veil of ignorance** to describe his notion that decisions about what is fair should be made blindly, without an after-the-fact awareness of what our ultimate attributes and attainments are.

Consider two scenarios.

As one choice, you can live in a society in which half of the population is very poor and half is very rich. The poor segment will struggle with satisfying its daily needs for food, shelter, and health care. The rich segment, in contrast, will live opulent lifestyles with yachts, vacation homes, and diamond jewelry.

Alternatively, you can choose to live in a society where all citizens enjoy a middle-class standard of living. No one is rich, and no one is poor.

FIGURE 4-2 The Wealth of the Richest 85 People Equals the Wealth of the Poorest Half of the World Population⁵



⁵ <http://www.cnbc.com/id/101105809>.

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Rawls contends that, if you had to make your choice under a veil of ignorance, without foresight about whether you ultimately will be in the rich group or the poor group, most people would opt for a society in which all members were equally well off.⁶

Example 4-2

Many countries and regions have enacted minimum wage laws. According to Rawls's Theory of Social Justice, how should society determine the dollar level of the minimum wage?

Solution

Rawls's theory of justice challenges us to think about what the proper level of the minimum wage should be, without being influenced by after-the-fact knowledge about whether we are an employer or a low-skilled worker.

Rawls's core conclusion is that, if social policies were determined prior to knowing our inborn characteristics and eventual destiny, we generally would opt to allocate resources equally. Thus, as a general matter, Rawls would set the minimum wage at far above its current level to ensure that the least fortunate have a standard of living that is roughly comparable to the most fortunate.

The Difference Principle

Rawls was a pragmatist who understood that if every citizen was assured an outcome of perfect equality, no one would have any incentive to work hard. Thus, Rawls set the equal sharing of wealth as an ideal goal, but then modified this view with what he called the **difference principle**. According to this principle, it is acceptable to provide greater rewards to some people as long as this difference also improves the welfare of those who are the least well-off.

Example 4-3

Ben and Jerry's Ice Cream Company once had a compensation policy that prohibited any employee from earning more than seven times the amount earned by the lowest-paid employee.⁷ However, when the company found it difficult to attract top key executives at such relatively low salary levels, the company relaxed this compensation policy. Was the company's decision to relax its compensation policies consistent with Rawls's Theory of Social Justice?

⁶ This concept also is rooted in the economic notion of diminishing marginal utility. For example, this principle states that the marginal utility of a poor person having adequate food is far greater than the marginal utility that a rich person correspondingly loses by sacrificing this amount of wealth.

⁷ https://www.law.upenn.edu/blogs/dskeel/archives/2008/09/the_war_on_executive_compensat.html

Solution

Yes. By relaxing its self-imposed maximum wage differential, the company was better able to attract key executives and operate a thriving company. Because this new policy maximized the opportunities, job security, and incomes of the company’s lower-paid workers, it satisfied Rawls’s difference principle.

The Neurobiology of Distributive Justice

For some, a just distribution of society’s resources is not just a political or economic goal; it is a biological imperative.

In a scientific experiment called the Ultimatum Game, participants hooked up to brain scanners were told that another person, called the *Giver*, was about to share a pool of money with them. If the Giver gave \$5 of his \$10 to the Receiver, this equitable offer activated the same brain regions that become excited when “we eat craved food, win money, or see a beautiful face,” said one researcher. Fairness “satisfies a basic need,” and “we apparently are wired to treat fairness as a reward.”⁸

In contrast, when the Giver gave the Receiver only \$5 out of \$23, the brain regions associated with disgust, rather than pleasure, were activated.⁹

Outside the laboratory setting, we can see this same phenomenon when, for example, people dance in the streets after learning of a just jury verdict or enthusiastically shout their approval when a football referee corrects an inaccurate touchdown call. Apparently, for many, justice tastes as sweet as candy.

FIGURE 4-3 Distributive Justice Summary

Theories of Distributive Justice	Core Philosophy
Aristotle	<ul style="list-style-type: none"> ▪ Equals should be treated equally ▪ Unequals should be treated unequally in proportion to the degree of their differences
Rawls	<ul style="list-style-type: none"> ▪ The distribution of wealth should be agreed upon as if a veil of ignorance prevented us from knowing our eventual traits, skills, and status in life ▪ The Difference Principle allows some people to receive greater rewards than others as this creates incentives that make the least fortunate better off as well

⁸ “Brain Reacts to Fairness as It Reacts to Money and Chocolate . . .,” UCLA Newsroom, April 21, 2008, citing research by UCLA Professor Matthew Lieberman.

⁹ Fairness activated the brain’s ventral striatum and ventromedial prefrontal cortex, whereas unfairness activated a disgusted response in the brain’s insula.

Virtue Ethics

As we previously have seen, many philosophies of ethics focus on the outcome of a specific act. Consequentialism focuses on whether an act generates a net societal benefit, deontology looks at whether a decision maker's act conformed to a duty, Aristotle's distributive justice view explores whether an act gives equal people equal treatment, and Rawls examines whether acts that benefit the most fortunate create outcomes that also benefit the least fortunate.

The **virtue ethics** philosophy, first propounded by Plato and Aristotle, is different. Rather than focusing on outcomes and concrete rules of action, virtue ethics focuses on improving *inputs* that develop a person's innate value system. These inputs may include education, parental teachings, peer discussions, attendance at professional association meetings, religious worship, and other forms of training that help prepare a person for the eventuality of making ethically correct decisions. To use a fire-fighting analogy, most philosophies focus on how a firefighter should behave when a forest is on fire. Virtue ethics instead focuses on making sure that rigorous training gives firefighters the strength and mental agility to face the daunting array of dangers they may one day encounter in dousing fires.

Adherents to virtue ethics promote a core set of traits that includes compassion, fairness, courage, honesty, integrity, wisdom, self-control, kindness, and loyalty.

The characters in the classic movie *The Wizard of Oz* provide a wonderful illustration of virtue ethics. The Tin Man seeks a heart so he can act with compassion and fairness. The Cowardly Lion pursues courage that will enable him to make brave, honest decisions that exemplify integrity. Their scatter-brained friend, Scarecrow, wonders out loud, "If I only had a brain," as he pursues wisdom and self-control. Last, throughout this epic tale, Dorothy displays kindness to her newfound friends and loyalty to her family and dog Toto as she ultimately "clicks her heels three times" to return home to the loved ones who raised her.

Example 4-4

As a young corporate staff accountant, you were surprised to overhear your supervisor say that she had "worked around" historical cost accounting principles to write up company real estate holdings to market value. When you probed further, you learned that the company sold appreciated land with a \$5 million cost for a price of \$7 million to a "friendly" real estate broker. Then, after the broker put this land into an offshore corporation, your employer paid this identical \$7 million to buy the land back from the offshore corporation.

Your supervisor, as a result, recognized a \$2 million gain on sale, which overstated the company's reported earnings. Also, the company reported the repurchased land on its year-end balance sheet at a \$7 million value, not at its historical cost of \$5 million. From the perspective of virtue ethics, what should you do?

Solution

Under virtue ethics, you hopefully have developed innate character traits that make you instinctively, and correctly, suspect that this transaction is deceptive and improper. Your wisdom and notions of fairness should make you question the propriety of this transaction, and your self-control and courage should impel you to inform the company's Audit Committee or directors about this supervisor's misconduct.

Egoism and Concern for Others

The Nature of Egoism

As we saw in the previous chapter, decision makers applying utilitarianism try to maximize the net benefits that inure to overall society.

Although utilitarianism is the most common form of consequentialism, consequentialism has other variations as well, including one called **egoism**. The philosophy of egoism, like all consequentialist approaches, looks at end results. However, egoism is solely concerned with maximizing the utility of a self-focused *decision maker*, not the utility of overall society.

Proponents of Egoism

The view that decision makers should only be concerned with themselves has been expressed in many different ways over the years. In ancient times, the philosopher Horace summarized the egoism viewpoint when he said, "Make money by honest means if you can; if not, by any means make money."¹⁰ More recently, actor Matthew McConaughey expressed a modern-day version of egoism: "I'm a fan of the word selfish. Self. Ish. When I say I have gotten a lot more selfish, I mean I am less concerned with what people think of me. I'm not worried about how I'm perceived. Selfish has always gotten a bad rap. You should do for you."¹¹

The self-focused nature of egoism frequently is ridiculed for being uncaring and myopic. However, it has its defenders, such as Nobel Prize-winning economist Milton Friedman. Professor Friedman would never have encouraged businesses to make money "by any means." He firmly believed that individuals and corporations alike are bound to abide

¹⁰ Horace, *Epistles*.

¹¹ <http://www.foxnews.com/entertainment/2013/11/14/matthew-mcconaughey-like-being-selfish/>.

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by the law, as well as by ethical customs. Nonetheless, he expressed a view that was akin to egoism: “There is one and only one social responsibility of business—to use its resources and engage in activities designed to increase its profits so long as it stays within the rules of the game, which is to say, engages in open and free competition without deception or fraud.”¹²

Friedman’s viewpoint encapsulates the neoclassic microeconomic models studied in introductory economics classes. One tenet of the perfect competition economic model is that resources are allocated most efficiently, and society most benefits, when individual market participants lawfully pursue their own well-being.

Friedman’s views echo those of early philosophers, such as Adam Smith. In 1776, during the birth of America, Adam Smith famously wrote of the economy’s *invisible hand* that guides us to prosperity: “It is not from the benevolence of the butcher, the brewer, or the baker that we expect our dinner, but from their regard to their own self-interest.”¹³ Every man “intends only his own gain . . . led by an invisible hand to promote an end which was no part of his intention. . . . By pursuing his own interest, he frequently promotes that of the society more effectually than when he really intends to promote it.”¹⁴

Author Ayn Rand was even more outspoken in expressing similar beliefs. She once wrote that “achievement of your happiness is the only moral purpose of your life,” and that she would “never live for the sake of another man, nor ask another man to live” for hers.¹⁵

Even ancient philosophers such as Aristotle wrote about the benefits that result from the pursuit of self-interest. According to Aristotle, a good in small quantities may have great value, but a saturation point eventually is reached at which having more of a good adds diminishing value to its owner. As a result, two property owners who have reached their respective saturation points can both be made better off by exchanging their goods with one another. In short, by acting purely out of self-interest, all participants in economic transactions are made better off.¹⁶

Critics of Egoism

Of course, not all philosophers, or entrepreneurs, agree with the self-interested nature of egoism. Henry Ford, one of America’s greatest in-

¹² Milton Friedman, “The Social Responsibility of Business is to Increase its Profits,” *The New York Times Magazine*, September 13, 1970.

¹³ Adam Smith, *An Inquiry into the Nature and Causes of the Wealth of Nations* (London: Strahan & Cadell, 1776).

¹⁴ Adam Smith, *The Wealth of Nations*, 1776. Also consider *The Theory of Moral Sentiments*, 1759.

¹⁵ Ayn Rand, *Atlas Shrugged* (New York: Random House, 1957).

¹⁶ Aristotle. *Politics*, Book 1.

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dustrialists, once stated that “a business that makes nothing but money is a poor kind of business.”

Henry Ford’s management style was an unusual mixture of generosity and paternalism. Ford paid workers far higher wages than other companies did. To qualify for this higher wage, though, workers had to allow the company’s *Socialization Committee* to inspect their homes to verify that they were avoiding destructive activities, such as gambling and excessive alcohol consumption. Immigrant workers also were required to learn English and attend classes to become *Americanized*. Many believe that Ford was motivated by a sincere concern for his employees. Cynics, however, suggest that his principal goal was to create a reliable workforce that would resist the temptation to unionize.

Henry Ford’s policies were heralded by many, but he also had many critics. When Ford Motor Company was sued for straying from its profit-seeking mission, a court had to remind Ford that “a business corporation is organized and carried on primarily for the profit of the stockholders.”¹⁷

Example 4-5

A car manufacturer has hired you as a consultant to help it decide whether to make its cars more fuel efficient. Depending on the materials used in the car and the horsepower of the car’s engine, this manufacturer can improve the fuel efficiency of its cars by up to an additional 7 miles per gallon. The company’s CEO believes in egoism and has told you that your only objective is to help maximize the company’s profits. Should you consider the impact on the environment in helping to formulate the company’s decision?

Solution

Probably not. To optimize the company’s profits, you should consider only those factors that will improve revenues or reduce costs.

You appreciate that improved fuel efficiency will also generate positive externalities for society, such as lesser pollution and lower dependence on imported oil. However, from the viewpoint of egoism, these considerations are relevant only if the marketing and public relations benefits of protecting the environment are valued by customers and, therefore, increase the decision maker’s sales and profits.

Corporate Social Responsibility

Here is a puzzle: A corporation has never paid a dividend in its nearly 100-year history, and its bylaws prohibit investors from reselling its

¹⁷ *Dodge v. Ford Motor Company*, 204 Mich. 459, 170 N.W. 668 (Mich. 1919).

stock for more than 25 cents per share. How much would you pay to buy this stock?

It may surprise you that over 250,000 people happily have purchased this stock at double-digit prices, fully aware that they overpaid millions of dollars. The stock is no ordinary stock; it is an ownership slice of the iconic Green Bay Packers football team. The buyers are not ordinary investors either. Rather, they are loyal Wisconsin *Cheesehead* fans who gladly overpaid because they know that the Green Bay Packers organization uses its profits to serve charities and other deserving stakeholders in its small community. These investors have soundly rejected egoism's parochial focus on profits and warmly embraced **corporate social responsibility**.

None of the Green Bay Packers benefactors will ever suit up for the game, catch the football, or stand anywhere near the huddle. Nonetheless, as believers in corporate social responsibility, they are team players in the truest sense.

The Nature of Corporate Rights and Duties

It is well established that corporations have numerous rights. Corporations have the right to enforce contracts, protect their inventions, and even exercise Constitutional rights under the First Amendment. For instance, corporations have certain free speech rights, such as the right to donate money to political candidates and the right to advertise the sale of liquor and other lawful products. Some corporations even have the right to freedom of religious expression. In a controversial 2014 decision, the U.S. Supreme Court exempted certain family-run corporations from having to provide contraceptives to female workers if doing so would violate the company's religious values.¹⁸

It is equally well established that corporations have responsibilities, but the scope and breadth of these obligations remain controversial. Does a corporation fulfill its responsibilities merely by adhering to laws and maximizing shareholder wealth? Or, does a corporation owe a broader set of ethical responsibilities to society? We will now examine two contrasting views, known as *shareholder theory* and *stakeholder theory*.

Shareholder Theory

According to **shareholder theory**, a corporation's sole duty is to maximize the welfare of its stockholders.

¹⁸ *Burwell v. Hobby Lobby Stores, Inc.*, U.S. Supreme Court, June 30, 2014.

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Imagine that you hired a smart friend to invest your money to earn the maximum profit attainable. If your friend instead spent your money in ways that did not further your goal, you surely would hold him accountable.

According to shareholder theory, corporate directors and officers, in economic terms, are like your smart friend. Investors entrust these individuals with capital and expect them to earn the maximum profit attainable. Unless they are given a different mandate, directors and officers have both the ethical and legal duty to manage a corporation in the best interests of the shareholders who effectively employ them.

Economist Milton Friedman summarizes this viewpoint as follows:

*A corporate executive is an employee of the owners of the business. He has direct responsibility . . . to conduct the business in accordance with their desires, which generally will be to make as much money as possible while conforming to the basic rules of the society, both those embodied in law and those embodied in ethical custom.*¹⁹

Billionaire Warren Buffett distinguishes between his personal responsibility to give to others and his duties as a corporate director to solely maximize shareholder profits. Although he has given billions of dollars to philanthropic causes in his individual capacity, Buffett nonetheless is skeptical about corporate philanthropy:

*When A takes money from B to give to C and A is a legislator, the process is called taxation. But when A is an officer or director of a corporation, we call it philanthropy.*²⁰

Rather than eliminate all acts of corporate social responsibility, Buffett decided that the company he manages, publicly traded Berkshire Hathaway, would divide charitable giving into two categories: “(1) Donations considered to benefit the corporation directly in an amount roughly commensurate with the cost of the donation and (2) Donations considered to benefit the corporation indirectly through hard-to-measure, long-delayed feedback effects of various kinds.”²¹ Berkshire Hathaway directly oversees donations in the first category, but allows its shareholders to designate the charities benefited by the second expenditure category. As Buffett declared, the company’s donations are “owner-directed” to “imitate more closely-held companies, not larger public companies.”

For many years, privately held Craigslist has been in a bitter ongoing battle with eBay, which is one of its three shareholders. Craigslist’s other

¹⁹ Milton Friedman, “The Social Responsibility of Business is to Increase its Profits,” The New York Times Magazine, September 13, 1970.

²⁰ The Essays of Warren Buffett: Lessons for Corporate America, by Buffett, in collaboration with Cunningham, p. 58.

²¹ Ibid, p. 59.

two shareholders are civic-minded individuals who believe that Craigslist’s mission is to serve its community of users, not to maximize short-run profits. Craigslist provides most of its Internet-based services free of charge, which irks profit-minded eBay. In a landmark victory for eBay and the shareholder theory, a Delaware judge admonished Craigslist’s directors that “the corporate form . . . is not an appropriate vehicle for purely philanthropic ends, at least not when there are other stockholders interested in realizing a return on their investment.”²²

Stakeholder Theory

Stakeholder theory asserts that a corporation owes a broad set of duties to the various constituencies that it affects. Stakeholders include all groups that are “vital to the survival and success of the corporation,”²³ including employees, customers, suppliers, community organizations, and governments.

Proponents of stakeholder theory contend that, just as individuals owe moral duties to their fellow citizens, corporations likewise have ethical obligations to the communities in which they conduct business. This viewpoint finds support in various philosophies. For example, utilitarians believe that ethical decisions must maximize the total welfare of all members of society, not just a subset of its members. Similarly, deontology speaks of a duty to respect the dignity of all people, and distributive justice requires successful corporations to share their largesse with less-fortunate stakeholders.

Contentions in Favor of Stakeholder Theory

Supporters of stakeholder theory point to numerous incidents, ranging from industrial explosions to oil spills, in which corporations have sacrificed safety and society in pursuit of higher profits. In particular, many point to Ford Motor Company’s Pinto car model as a prototypical example of the catastrophic consequences that can result when cost accounting calculations have primacy over common sense.

While trying to compete in the 1970s against small imported cars, Ford Motor Company discovered that its much-awaited small car, the Pinto, had a serious design defect. In the event of a rear-end collision, the Pinto’s gas tank could explode into flames, causing severe injuries to the car’s passengers.

²² *eBay Domestic Holdings, Inc. v. Craigslist*, et al., Delaware Court of Chancery, Case No. 3705-CC, September 9, 2010.

²³ W. Evan and R. E. Freeman, “A Stakeholder Theory of the Modern Corporation: Kantian Capitalism,” in *Contemporary Issues in Business Ethics*, 4th ed., ed. J. DesJardins and J. McCall (Belmont, CA: Wadsworth, 2005).

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The Pinto was already in its preproduction phase, however, and Ford’s management did not want to delay its introduction. As a result, well aware of the Pinto’s fire hazards, Ford nonetheless decided to market the Pinto to an unsuspecting public.

After this defect was implicated in numerous tragic accidents, investigators discovered a document in which Ford’s cost accountants had performed a disturbing *breakeven* analysis. If Ford were to fix the Pinto’s defective design, this document showed that it would incur well over \$100 million in costs. Alternatively, if Ford simply allowed the problem to persist, Ford’s accounting analysis dispassionately estimated that the costs of compensating accident victims, at a “unit cost” of \$200,000 per death and a lesser amount per injury, would be only about \$50 million. Weighing these cost alternatives, Ford Motor Company decided to continue the Pinto rollout, knowing that an average of 180 additional drivers would die in fiery explosions and thousands more would suffer disfiguring burn injuries. As one commentator starkly stated, after crunching the numbers, Ford Motor Company decided, “Let ’em burn.”²⁴

FIGURE 4-4

What Is the Value of a Year of Life?²⁵

It is easy to criticize the use of cost accounting analysis in deciding matters of life and death, as occurred in the Ford Pinto case. However, the value of life has to be computed in many situations, including wrongful death damages lawsuits, drug approval decisions, and environmental safety determinations. Economists attempt to estimate the value of life statistically by examining the risk premiums earned by workers in risky occupations. For instance, members of the military receive about a \$2,000 yearly bonus for specified hazardous jobs, such as handling chemical weapons, servicing missiles—even landing “ski-enabled aircraft on the Arctic icepack.”

In deciding whether to pay for medical treatments, healthcare professionals commonly value one extra *high-quality statistical year of life* at \$50,000. Thus, if a new medical procedure will extend a person’s life by an average of two years, health insurers ordinarily will pay up to about \$100,000 for it. To eliminate risks that save one *full statistical life*, government safety regulations usually require businesses to spend up to about \$9 million.

How much would you pay for an extra year of life? If someone were to deprive you of a year of life, how much would you insist that they pay you?

²⁴ Dan Neil, “The 50 Worst Cars of All Time,” *Time* (September 7, 2007).

²⁵ United States Military Pay and Allowances; “As U.S. Agencies Put More Value on a Life, Businesses Fret,” *The New York Times*, February 16, 2011.

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It is often said that those who forget the past are condemned to repeat it.²⁶ Despite having the Ford Pinto debacle as a prologue, General Motors failed to heed its lesson about stopping a small design defect before it becomes a huge disaster. In 2014, investigators discovered that engineers at General Motors knew that the ignition switch on certain cars would shut off while driving, leaving drivers without the power to steer or brake. After many deaths, Congressional hearings, lawsuits, and widely publicized accusations about its lack of social responsibility, General Motors recalled millions of cars at a cost exceeding a billion dollars. And what was the cost of each replacement ignition switch? 57 cents.²⁷

Example 4-6

A major retailer has decided to pay double-time pay to employees who work on certain holidays. The retailer announced that it implemented this pay increase “in recognition of our hardworking, dedicated workers who deserve increased compensation to provide for their families’ needs, especially during holiday season.”

To control its costs, this retailer also has decided to reduce the number of staff members who work on such holidays. Does this decision make the retailer’s stakeholders better off or worse off?

Solution

It is impossible to know if this decision helps or hurts stakeholders overall. This decision directly affects the company’s employees. Those who are fortunate to be assigned to work on holidays clearly will earn more money for their labor. As the number of employees working on holidays shrinks, however, other employees, will lose their holiday incomes altogether.

Also, because of the cutback in store personnel, customers may become infuriated by inferior customer service, causing them to buy fewer goods. As sales volumes decline, the company’s suppliers will generate less income, and local governments will collect less sales tax for use in supporting public services.

Contentions against Stakeholder Theory

In denigrating stakeholder theory, critics assert that corporations already promote the broader social welfare by creating jobs, advancing technology, delivering goods and services that satisfy consumers’ desires, and paying taxes that support worthy social programs and public projects.

²⁶ George Santayana, *Reason in Common Sense, The Life of Reason*, Vol. 1 (Mineola, NY: Dover Press, 1980).

²⁷ Associated Press story, April 1, 2014.

Critics further contend that corporations are ill-equipped to ascertain if their decisions, on balance, help or hurt various stakeholders. For example, proponents of the natural resource extraction process called *fracking* contend that it creates jobs, lowers gas prices, reinvigorates rural communities, and enhances America's energy independence. According to environmentalists, however, fracking may contaminate groundwater, release greenhouse gases that contribute to climate change, and pose unknown risks to our health and welfare. Does fracking, on balance, help or harm society?

Sustainability and Corporate Social Responsibility

Decades ago, Oskar Schindler was an opportunist who later epitomized the principles of **corporate social responsibility**, or **CSR**. As the Academy Award-winning movie *Schindler's List* chronicles, Schindler was a hard-nosed German businessman who hoped to capitalize on the Nazis' rise to power by setting up a factory run by cheap Jewish laborers herded into Polish detention camps. After observing the cruel treatment in the death camps, however, Schindler shifted his business focus from making money to serving humanity.

As the war continued, Schindler spent large sums bribing Nazi officials to give him more Jewish workers, ostensibly to expand his business. His true motive, though, was to spare the lives of these detainees. By the time that the Allied forces prevailed over Hitler, Schindler had sacrificed his personal fortune to spare over 1,000 lives from certain death. Schindler's devotion was a wonderful display of conscience, as well as one of the greatest examples of corporate social responsibility in modern history.

Corporate social responsibility is a natural extension of stakeholder theory. It is often said that to do well, businesses first must *do good*. Many professional services firms, such as accounting and law firms, encourage, or even require, their personnel to devote time to unpaid public-interest work. These activities commonly are referred to by the Latin phrase *pro bono*, which means "for the public's good."

Defining Corporate Social Responsibility

The concept of *doing good* has defied precise delineation, with one scholar calling corporate social responsibility an "eclectic field with loose boundaries."²⁸ Three different meanings often are ascribed to the phrase "corporate social responsibility (CSR)."

²⁸ A. B. Carroll, "Social Issues in Management Research," *Business and Society* 33, no. 1 (1994): 5–25.

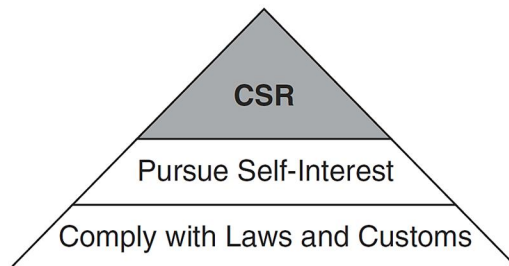
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According to the International Organization for Standardization, CSR is the “responsibility of an organization for the impacts of its decisions and activities on society and the environment through transparent and ethical behavior.”²⁹ Most commentators, however, do not adopt this view that mere compliance with ethical and legal norms qualifies as *social responsibility* because all citizens are held to this minimal standard.

An alternate definition has been established by the Australian Securities and Investment Commission. According to this standard of CSR, entities must “voluntarily integrate social and environmental factors into their operations and their interaction with their stakeholders, which are *over and above* the entity’s legal responsibilities.”³⁰ Under this definition, a toy company that develops a line of educational toys that stimulates children’s brain development would be engaged in CSR, even if the company’s sole motive was to make more money, not to benefit society.

Finally, among academicians, CSR commonly is defined even more narrowly as the set of “actions that appear to serve some social good, *beyond* the interests of the firm and that which is required by the law.”³¹ Under this definition, creating a safer workplace surely creates “social good.” However, if the company’s purpose for creating a safer workplace was to boost profits by cutting workers’ compensation costs, its expenditure would not qualify as a CSR act because the company lacked the intent to serve social good *beyond* pursuing its self-interest and obligations to comply with the law. To establish a consistent framework for analysis, this definition shall be used throughout this chapter.

FIGURE 4-5 What Is CSR?



²⁹ “ISO 26000: Guidance on Corporate Social Responsibility,” 2012.

³⁰ Australian Securities and Investment Commission, AS8303.2003 (emphasis added).

³¹ Abigail McWilliams and Donald Siegel, “Corporate Social Responsibility: A Theory of the Firm Perspective,” *The Academy of Management Review* 26, no. 1 (Jan. 2001): 117–127 (emphasis added).

Example 4-7

A group of physicians closed their medical corporation to provide medical care to impoverished citizens of a small tropical island that suffered a devastating earthquake. By temporarily closing their office, these physicians lost income and suffered a loss of goodwill with their existing patients. Did this medical group engage in an act of corporate social responsibility?

Solution

Yes. These doctors were not motivated by financial gain or compliance with legal norms. Indeed, the doctors lost income and antagonized existing patients. Their actions exemplified CSR because they made a contribution to society that surpassed their self-interest and legal requirements.

Accounting for CSR

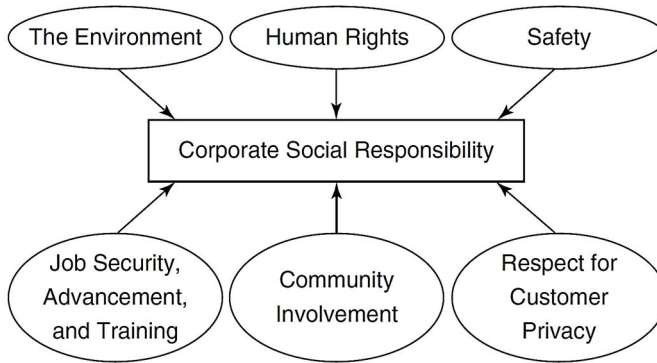
Nobel Prize-winner Joseph Stiglitz says that measuring national welfare by only computing Gross Domestic Product is like a car having “a dashboard [with] only one gauge . . . GDP tells you nothing about sustainability.” “There needs to be a focus on what we call *Green GDP*—taking account of environmental degradation and resource depletion.”³²

The *Global Reporting Initiative* is a joint venture of various organizations, including accounting regulatory bodies, that has developed a comprehensive framework for assessing and reporting corporate social responsibility. Although the specific elements of *doing good* continue to evolve, the Global Reporting Initiative has identified the following benchmarks for evaluating corporate citizenship:

- Environmental sustainability, including the use of renewable energy, abatement of water and air pollution, secure disposition of hazardous wastes, recycling, and resource conservation
- Respect for human rights, humane working conditions, and diverse cultures
- Employment practices that foster workplace safety, job security, and opportunities for advancement
- Community involvement, such as through investment in the arts and education
- Ethical business practices that enhance customer privacy and do not sanction corrupt or anticompetitive practices

³² Joseph Stiglitz, “The Rise and the Fall of the G.D.P.,” *The New York Times*, May 13, 2010.

FIGURE 4-6 Corporate Social Responsibility



The *Sustainability Accounting Standards Board*, or SASB, is a privately funded, nonprofit organization that is developing similar industry-specific standards for possible adoption by the SEC. Its approach is to encourage corporations to report a *triple bottom line* that reflects their financial, social, and environmental performance. John Elkington, the founder of British consulting firm *Sustain-Ability* calls this three-pronged approach the “three Ps” of reporting: Profit, People, and Planet.

The first official mandate of CSR accounting took effect in 2014, which supporters of CSR reporting heralded as a historical event. In accordance with the Dodd–Frank Act, American companies have to disclose in audited SEC filings whether inhumane central African militias supply them with so-called *conflict minerals*.³³ To comply with this new rule, Intel issued the following disclosure:

*Conflict minerals originating from the Democratic Republic of the Congo (DRC) and adjoining countries are sometimes mined and sold, under the control of armed groups, to finance conflict and violence. . . . We have worked diligently to put the systems and processes in place to enable us to reasonably conclude that the tantalum, tin, tungsten and gold in our products do not finance or benefit armed groups in the region. . . .*³⁴

In 2014, India as well imposed both CSR spending and accounting mandates on large firms doing business there. According to India’s new *Companies Act*, covered companies must spend a minimum of 2% of their domestic profits on CSR activities, such as providing preventative

³³ Conflict minerals often are extracted from the earth using forced laborers who have been intimidated by acts of torture and rape.

³⁴ <http://www.intel.com/content/dam/doc/policy/policy-conflict-minerals.pdf>.

health care, improving public sanitation, and sheltering the homeless. For this purpose, expenditures that improve the well-being of workers and their families do not qualify as CSR expenditures.³⁵

The Importance of CSR Accounting

The importance of a company's image cannot be underestimated. According to the private consulting firm Reputation Institute, 60% of consumers' willingness to buy from a company depends how they perceive the company's reputation.³⁶ Research in Europe suggests that a corporation's reputation for social responsibility is, on average, even more important to Western European consumers than to American consumers.

The Reputation Institute's study further states that a company's reputation in turn hinges on three key ingredients of CSR, which it labels Citizenship, Governance, and Workplace. Recently, Disney topped this study's list because of its efforts in promoting the well-being of families and minimizing its environmental impact.³⁷

Emerging Challenges in CSR Accounting

Even supporters of CSR acknowledge that the emerging field of CSR reporting has its limitations.

First, it is not always clear if a well-meaning act actually promotes *social good*. To illustrate, does a company achieve social good when it closes a high-polluting coal-powered manufacturing plant, but its actions cause massive unemployment and bankruptcies in a nearby coal mining town? Or, consider the decision by top movie theater chains in 2014 to cancel showing the comedy *The Interview* when offended North Korean officials satirized in the film purportedly threatened to incite terrorist acts at theaters exhibiting it. Did these theaters achieve social good by protecting patrons against harm? Or would they have better promoted social good by exhibiting this movie, in defiance of these threats and in support of freedom of expression?

Consider, too, the plight of Duke Power Company. Duke thought that it was accomplishing social good when it built a renewable wind energy project in Wyoming. However, Duke's project angered conservationists because the massive spinning blades on its turbines killed endangered species, such as golden eagles.³⁸ Although environmental regulators who initially favored Duke's project knew that harm to unsuspecting

³⁵ "Mandatory 2% CSR spend set to kick in from April 1," The Indian Express, February 28, 2014.

³⁶ <http://www.reputationinstitute.com/thought-leadership/white-papers>.

³⁷ <http://www.forbes.com/sites/jacquelynsmith/2013/10/02/the-companies-with-the-best-csr-reputations-2/>.

³⁸ "Wind Power Is Brought to Justice," Wall Street Journal, November 29, 2013.

birds would be an unavoidable by-product, they nonetheless imposed a \$1 million fine on Duke for violating the Migratory Bird Treaty Act.

FIGURE 4-7

Is Charitable Giving Irrational?

You have \$100 that you wish to donate to a good cause. You have two choices.

You can donate to a trustworthy charitable fund that will provide diphtheria vaccines to poor children in the Russian-speaking country of Azerbaijan. Your donation will enable three children out of several thousand to be protected from a disease that, if untreated, can significantly damage internal organs.

Alternatively, you can donate to a trustworthy charitable fund for an 18-month-old rural Texas girl known as *Baby Jessica*. Jessica's plight was captured by continuous live television coverage after she fell down a backyard well and remained trapped for over two days until rescuers could save her. She had to have one toe amputated due to a loss of circulation, but otherwise was fine. Your donation will be invested to help pay for her future college education.

Which charity will you select?

If you are like most people, you will donate to the *Baby Jessica* fund. Research shows that people donate to beneficiaries whose plight is vivid, whose identities are known, and who are members of a group with which we feel a kinship or connection. A request for preventive care for unknown people in a far-away land does not trigger an emotional response that leads to charitable giving. A single little girl seen on television, however, does. This is known as the *identifiable victim effect*.

In actuality, Baby Jessica tumbled down the well in 1987. Consequently, we now know from hindsight that the funds raised for her far exceeded potential college costs and that, in fact, she never pursued further education after finishing high school. As a result, many well-meaning donors deluged Jessica with unneeded donations, while millions of deserving but nameless children remained hungry, homeless, and helpless around the world.

In addition, as we have discussed, not all acts that benefit the public interest are considered to be CSR. For example, compliance with the law, such as implementing mandated safety and labor regulations, is not considered a CSR act. Moreover, actions implemented by a corporation in pursuit of its narrow self-interest are not considered CSR. For example, corporations that shift to recyclable packages solely to cut costs or em-

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brace *all-natural ingredients* solely to attract health-conscious consumers are not engaged in CSR.

Unfortunately, it can be challenging to distinguish between true acts of CSR and mere publicity stunts. As a result, in evaluating CSR accounting, it is important to probe whether an act truly is motivated by the public interest or whether it merely is a cynical profit-seeking ploy designed to manipulate the public.

Example 4-8

After a tanker truck owned by a large oil refinery accidentally dumped small amounts of hazardous waste near an elementary school, the company paid \$200,000 to the local authorities for cleaning up the hazardous waste. It also spent \$70,000 on health exams and psychological counseling to ensure that nearby schoolchildren were not adversely affected.

What amount, if any, did this company spend on CSR?

Solution

Zero. Payment of the cleanup costs likely was required by law.

Furthermore, the company, faced with potentially costly lawsuits, merely acted out of self-interest when it spent money on health care for the schoolchildren.

Example 4-9

A company makes specialty steel products in high-temperature industrial ovens. It recently became the first company in its industry to shift to a fully automated production facility, in part to reduce labor costs.

After revamping its facilities and laying off workers, the company began lobbying government regulators and the general public, claiming that it “had a moral duty to denounce the barbaric, high-temperature working conditions” in its industry. Was the company’s lobbying campaign an act of CSR?

Solution

No. The company anticipated that others would accuse it of harming the public interest by laying off so many workers. To blunt these possible accusations, the company launched a publicity campaign decrying working conditions in the industry. Although the company portrayed itself as acting in the public interest, it merely was acting out of self-interest to deflect criticism and improve its reputation for being a concerned corporate citizen.

The Impact of CSR on Financial Results

Does being a good corporate citizen affect a company’s stock performance?

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Researchers valiantly have tried to answer this question, but they encounter great difficulties in distinguishing a true CSR act from a self-promoting public relations act.

Consider the following excerpt from candy maker Hershey's Corporate Social Responsibility Report:

West Africa is a region of continuing focus for our company. It is where we source the majority of Hershey cocoa—our most important commodity. We understand that improving sustainable cocoa farming practices leads to better lives for cocoa workers and their families. . . . We have expanded our commitment to cocoa communities in West Africa through a five-year, \$10 million investment in innovative sustainability and sourcing initiatives.³⁹

Is Hershey pursuing these sustainable farming practices out of compassion and concern for others? Or, is its true purpose to secure a stable source of cocoa that will be supplied by efficient, content workers? Or, possibly both reasons?

Furthermore, even if stock market researchers could identify pure CSR expenditures, it would still be difficult to gauge the impact of CSR acts on stock performance because CSR-focused companies tend to have characteristics that differ from other corporations. According to some studies, companies that spend significant funds on CSR are likely to be prosperous, image-conscious firms that have the resources to fund discretionary spending on CSR. Commonly, these companies are well-established marketers of consumer products, such as Nestle, Johnson and Johnson, Microsoft, Toyota, and major European automakers.

Example 4-10

Which of the following elements typically characterize corporations that spend significant sums on CSR?

- They spend substantial amounts on advertising.
- They produce industrial products rather than consumer products.
- They operate in highly competitive markets.
- They spend modest amounts, if any, on research and development.

Solution

Only the first characteristic tends to be present in companies that spend generously on CSR. Studies have shown that companies tend to engage in CSR acts when they operate in markets where brand image is important. As a result, CSR-oriented companies tend to advertise extensively and produce consumer goods for sale to the general public.

³⁹ Hershey Corporation, Corporate Responsibility Report, 2011, p. 3.

Also, CSR-oriented firms tend to have some degree of monopoly power and brand differentiation, as well as a focus on long-term profitability and goodwill. Thus, CSR-oriented firms do not tend to operate in markets where cutthroat competition is present. Instead, they tend to spend significantly on research and development to preserve the distinctiveness of their products.

Nonetheless, recent research suggests that firms with high levels of CSR expenditures do tend to generate above-average profitability and stock performance.⁴⁰ The key question, though, is: Do high CSR expenditures *cause* superior financial performance, or does superior financial performance generate excess cash flow that *enables* firms to make generous CSR expenditures? Or as another possibility, perhaps there is a positive feedback cycle in which one element reciprocally enhances the other element? More research is needed before definitive answers can be reached.

The Future of CSR

The intensity of the debate over CSR is not likely to diminish any time soon. Jack Welch, the former CEO of General Electric, for example, remains a stalwart proponent of profit-maximization. In discussing whether alternative-energy projects need to generate money as well as power, Welch contends that, “if it doesn’t turn green to green,” a business project is not worth undertaking.⁴¹

Conversely, law professor Lynn Stout fiercely criticizes corporations that relentlessly focus only on profits and short-term stock price increases. She insists that because corporate shareholders have diverse goals, management’s exclusive focus on profits often harms the very shareholders that the corporation professes to benefit. The age-old dogma of only maximizing shareholder value, she says, “privileges the interests of the most myopic, opportunistic, self-destructive, psychopathically asocial subset of shareholders,” to the detriment of others.⁴²

Do Accounting Rules Discourage Corporate Social Responsibility?

When a company contributes to a worthy charitable cause, its expenditures often benefit the company’s long-term reputation. However, from an accounting standpoint, charitable contributions are expensed rather than capitalized. As a result, companies that wish to support charitable causes may be dissuaded from doing so because charitable expenditures

⁴⁰ See, for example, Caroline Flammer, “Corporate Social Responsibility and Stock Prices: The Environmental Awareness of Stockholders,” *Academy of Management Journal* 56, no. 3 (June 1, 2013): 758–781.

⁴¹ Jack Welch, quoted in Aman Singh, “GE May Be Going Too Green,” *Forbes*, March 3, 2011.

⁴² <http://blogs.law.harvard.edu/corpgov/tag/lynn-stout/>.

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lower reported profits, at least in the short run, and do not appear as assets on their balance sheets.

Similarly, expenditures on employee training must be expensed under GAAP, even though these costs improve employees' contentment and future productivity. Likewise, technological advances that improve product safety or create sustainable production techniques usually must be expensed as Research and Development, hurting short-run reported profits.

Due to these perverse accounting effects, some commentators have suggested that the accounting profession should permit reputation-enhancing expenditures to be capitalized as a stand-alone intangible asset called *CSR Investment Rights*, much like Goodwill is capitalized as part of an acquisition.

Example 4-11

By spending substantial sums on research, the coal industry has successfully reduced the environmental impact of burning coal. By reducing air pollutants, such as sulfur dioxide and nitrogen oxides, coal companies and utilities have significantly helped reduce acid rain and smog.

The coal industry's efforts have contributed to a cleaner environment. Also, by making coal a viable energy source, the coal industry has increased the value of its coal reserves. How should the coal industry account for research efforts aimed at reducing other pollutants associated with coal, such as greenhouse gases?

Solution

Under GAAP, the company must expense these costs, even though the coal industry's research economically is an investment in a cleaner environment, as well as an investment in the value of its coal reserves. Many contend that GAAP should be changed because expenditures that help maintain the ongoing viability of the coal industry hurt companies' reported short-run profits, despite the long-run benefits.

Solution to “Am I Ethical?”

[C]

According to Aristotle's philosophy of distributive justice, “equals should be treated equally.” In applying this principle, the U.S. Supreme Court determined that it was unconstitutional for the IRS to deny an estate tax exemption to same-sex couples that was freely available to opposite-sex couples.

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The historical interpretation of the term *surviving* spouse is irrelevant. Ethical rules evolve over time.

The IRS's duty to collect tax revenues is irrelevant in assessing whether an act is ethical. Collecting taxes in a certain manner is not a fundamental element of deontology.

The legal aspects of this issue were decided in 2013 by the U.S. Supreme Court in the case *United States v. Windsor*.

Review Questions

1. Of the following, which philosophy focuses on improving inputs that develop a person's innate value system?
 - A. Veil of ignorance
 - B. Difference principle
 - C. Distributive justice
 - D. Virtue ethics

2. Egoism is solely concerned with maximizing the utility of what group?
 - A. Stakeholders
 - B. Overall society
 - C. Self-focused decision makers
 - D. Unequals

3. Corporate social responsibility is a natural extension of what theory?
 - A. Rawls
 - B. Stakeholder
 - C. Shareholders
 - D. Invisible hand

Review Answers

1.
 - A. Incorrect. Veil of ignorance is not a philosophy that focuses on improving inputs that develop a person's innate value system. Veil of ignorance describes the notion that decisions about what is fair should be made blindly, without after-the-fact awareness.
 - B. Incorrect. The difference principle is not a philosophy that focuses on improving inputs that develop a person's innate value system. According to the difference principle, it is acceptable to provide greater rewards to some people as long as this difference also improves the welfare of those who are the least well off.
 - C. Incorrect. Distributive justice is not a philosophy that focuses on improving inputs that develop a person's innate value system. The core proposition of Aristotle's theory of distributive justice is that equals should be treated equally.
 - D. **Correct.** The virtue ethics philosophy focuses on improving inputs that develop a person's innate value system.

2.
 - A. Incorrect. Egoism is not solely concerned with maximizing the utility of stakeholders. Stakeholders include all groups that are vital to the survival and success of the corporation.
 - B. Incorrect. Egoism is not solely concerned with maximizing the utility of overall society. Egoism does not impact the utility of such a large group as society as a whole.
 - C. **Correct.** Egoism is solely concerned with maximizing the utility of a self-focused decision maker.
 - D. Incorrect. Egoism is not solely concerned with maximizing the utility of unequals. The theory of distributive justice established a corollary principle that concluded that unequals should be treated unequally.

3.
 - A. Incorrect. Corporate social responsibility is not a natural extension of the Rawls theory. Thomas Rawls developed a theory of social justice that reasoned that to achieve a just society, societal principles must be established that are not biased by the endowments with which individuals are either blessed or cursed.
 - B. **Correct.** Corporate social responsibility is a natural extension of the stakeholder theory.
 - C. Incorrect. Corporate social responsibility is not a natural extension of the shareholder theory. According to the shareholder theory, a corporation's sole duty is to maximize the welfare of its stockholders.

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- D. Incorrect. Corporate social responsibility is not a natural extension of the invisible hand theory. Adam Smith famously wrote in 1776 of the economy's "invisible hand" that guides people to prosperity.

Glossary

CARE: A general framework for accounting professionals to use in resolving ethical conflicts; expressed using the acronym: C (consider all the facts); A (assess the available alternative courses of action); R (review the ethical issues); and E (evaluate the consequences of each alternative course of action).

Code of Conduct: The collective core principles of ethical conduct embodied in both the AICPA Code of Professional Conduct and the IFAC Code of Ethics for Professional Accountants.

Code of Conduct Principles: AICPA Code principles applicable to all members of the accounting profession, including: Responsibilities, Public Interest, Integrity, Objectivity and Independence, Due Care, and Scope and Nature of Services.

Consequentialism: A decision-making approach under which a decision is judged to be ethical if it improves the collective happiness of those that are affected by it.

Corporate social responsibility: A company's actions that are intended to serve social good beyond pursuing its self-interest and obligations to comply with the law.

Deontology: A decision-making approach under which people innately owe certain duties to each other and should conform to this mandate, without regard to how their actions impact society.

Distributive justice: The focus on how individuals should share society's resources and burdens.

Dual processing: Occurs when the emotional and the analytical regions of the brain compete with each other to dominate individuals' decisions.

Egoism: A decision-making philosophy that is solely concerned with maximizing the utility of a self-focused decision maker, not the utility of overall society.

Ethical absolutism: The thought that ethical rules are universal and immutable, evidenced by the Golden Rule of "Do unto others as you would have others do unto you."

Glossary

Ethical relativism: The assertion that rules of morality evolve over time and vary among cultures, religions, and political structures.

Ethics: Norms that guide individuals in identifying right from wrong, good from bad, and just from unjust; including “normative ethics” which focuses on how people should behave, and “behavioral ethics,” which examines how people in fact behave.

Kohlberg’s Stages of Moral Development: A six-stage model of moral reasoning representing the sequential steps of reaching more advanced levels of ethical reasoning over time due to training and life experience.

Rawl’s Theory of Social Justice: A philosophy of distributive justice, furthered by the notion that decisions about what is fair should be made blindly, without an after-the-fact awareness of what individuals’ ultimate attributes and attainments are (the “veil of ignorance”).

Rest’s Four-Component Model: A four-step action plan for making and implementing ethical decisions, including: Sensitivity, Judgment, Intent, and Character.

Reversibility principle: Implores people to evaluate their behavior by mentally reversing their role from being the giver of an act to being the receiver, or vice versa.

Shareholder/Stakeholder theories: According to the shareholder theory, a corporation’s sole duty is to maximize the welfare of its stockholders; whereas, the stakeholder theory asserts that a corporation owes a broad set of duties to the various constituencies that it affects.

Universality principle: According to this principle, certain duties and corresponding rights apply globally to all people, in all situations.

Utilitarianism: Under this framework, an act is ethical if, on balance, it improves the overall well-being, or utility, of all members of society.

Virtue ethics: Rather than focusing on outcomes and concrete rules of action, this philosophy focuses on improving inputs that develop a person’s innate value system.

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