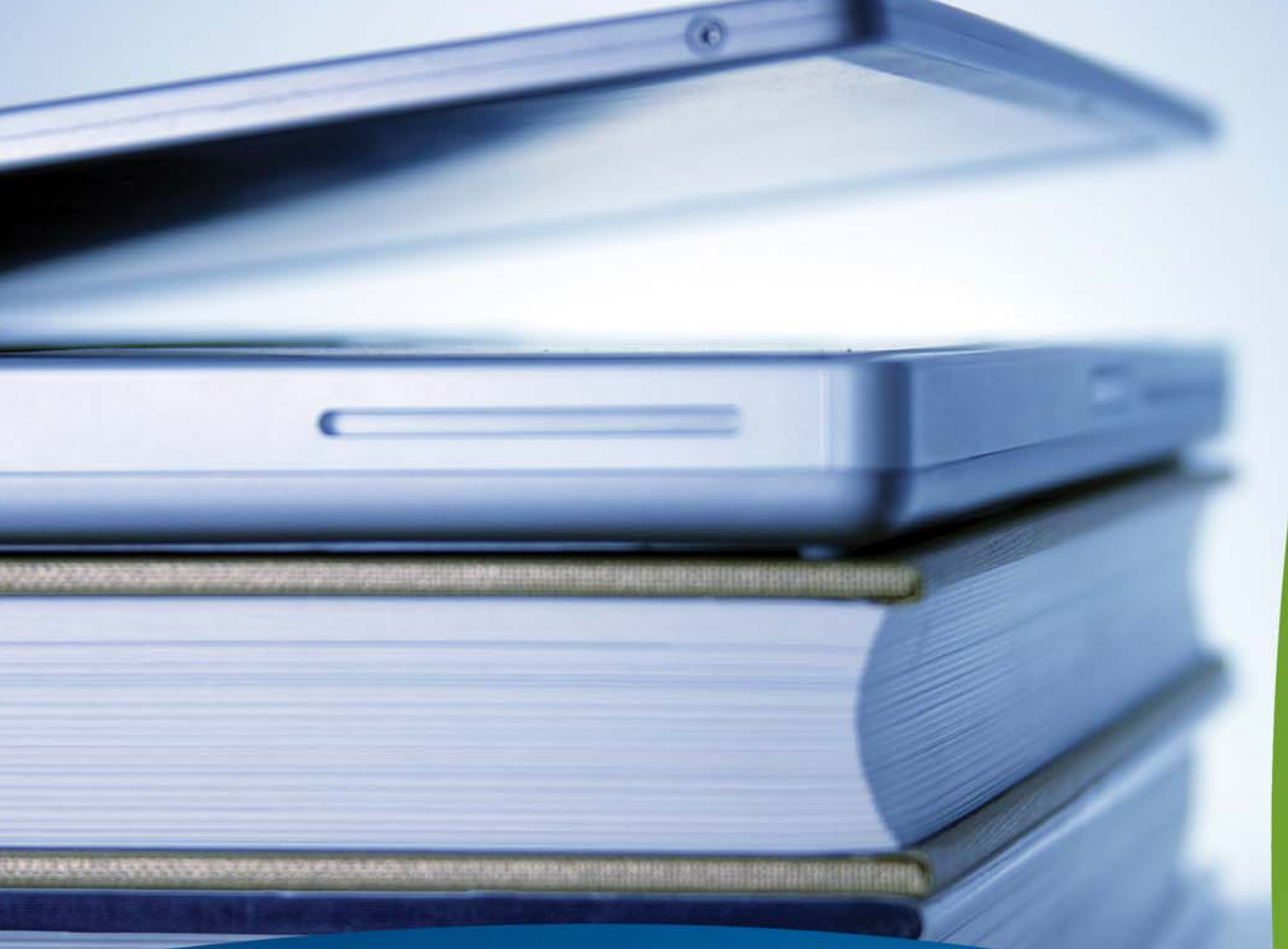

WESTERN™ CPE
Innovative Education

Behavioral Ethics

Steven M. Bragg

Course # 4160636, Version 1910, 2 CPE Credits

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Course CPE Information

Course Expiration Date

Per AICPA and NASBA Standards (S9-06), QAS Self-Study courses must include an expiration date that is ***no longer than one year from the date of purchase or enrollment***.

Field of Study

Behavioral Ethics. Some state boards may count credits under different categories—check with your state board for more information.

Course Level

Overview.

Prerequisites

There are no prerequisites.

Advance Preparation

None.

Course Description

This course discusses the different theories of how people deal with ethical dilemmas and goes on to cover a number of issues that can impact these decisions. Examples of these issues are contextual factors, the ethical infrastructure of a business, the role of leaders, and employee interactions with management. The course also addresses the fraud triangle, fraud addiction, whistleblowing, and several similar topics.

Publication/Revision Date

October 2019

Instructional Design

This Self-Study course is designed to lead you through a learning process using instructional methods that will help you achieve the stated learning objectives. You will be provided with course objectives and presented with comprehensive information and facts demonstrated in exhibits and/or case studies. Review questions will allow you to check your understanding of the material, and a qualified assessment will test your mastery of the course.

Please familiarize yourself with the following instructional features to ensure your success in achieving the learning objectives.

Course CPE Information

The preceding section, "Course CPE Information," details important information regarding CPE. If you skipped over that section, please go back and review the information now to ensure you are prepared to complete this course successfully.

Table of Contents

The table of contents allows you to quickly navigate to specific sections of the course.

Learning Objectives and Content

Learning objectives clearly define the knowledge, skills, or abilities you will gain by completing the course. Throughout the course content, you will find various instructional methods to help you achieve the learning objectives, such as examples, case studies, charts, diagrams, and explanations. Please pay special attention to these instructional methods, as they will help you achieve the stated learning objectives.

Review Questions

The review questions accompanying this course are designed to assist you in achieving the course learning objectives. The review section is not graded; do not submit it in place of your qualified assessment. While completing the review questions, it may be helpful to study any unfamiliar terms in the glossary in addition to course content. After completing the review questions, proceed to the review question answers and rationales.

Review Question Answers and Rationales

Review question answer choices are accompanied by unique, logical reasoning (rationales) as to why an answer is correct or incorrect. Evaluative feedback to incorrect responses and reinforcement feedback to correct responses are both provided.

Glossary

The glossary defines key terms. Please review the definition of any words you are not familiar with.

Index

The index allows you to quickly locate key terms or concepts as you progress through the instructional material.

Qualified Assessment

Qualified assessments measure (1) the extent to which the learning objectives have been met and (2) that you have gained the knowledge, skills, or abilities clearly defined by the learning objectives for each section of the course. Unless otherwise noted, you are required to earn a minimum score of 70% to pass a course. If you do not pass on your first attempt, please review the learning objectives, instructional materials, and review questions and answers before attempting to retake the qualified assessment to ensure all learning objectives have been successfully completed.

Answer Sheet

Feel free to fill the Answer Sheet out as you go over the course. To enter your answers online, follow these steps:

1. Go to www.westerncpe.com.
2. Log in with your username and password.
3. At the top right side of your screen, hover over "My Account" and click "My CPE."
4. Click on the big orange button that says "View All Courses."
5. Click on the appropriate course title.
6. Click on the blue wording that says "Qualified Assessment."
7. Click on "Attempt assessment now."

Evaluation

Upon successful completion of your online assessment, we ask that you complete an online course evaluation. Your feedback is a vital component in our future course development.

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Table of Contents

Chapter 1 - Behavioral Ethics

Learning Objectives

Upon successful completion of this course, participants will be able to:

- Identify the categories of ethical positions that a person may hold.
- Note the different types of core virtues.
- Recognize the different types of ethical weaknesses in a business environment.

Introduction

Ethical lapses are a common issue in business today, with fraudulent activities and the mistreatment of employees routinely appearing in the news. These lapses are not unique to smaller organizations – even the largest and most long-term institutions with well-designed control systems have been negatively impacted. When consumers and investors can no longer trust organizations or other individuals to behave properly, it has a deep and negative impact on how they perceive the business environment.

Behavioral ethics is the study of how people reason about and make decisions concerning right and wrong when confronted with an ethical dilemma. The emphasis is on the quality of the reasoning that goes into an ethical decision, rather than the ethical decision reached. In this course, we discuss behavioral ethics within the context of the business environment, which also includes the actions that can be taken to minimize ethical problems.

Ethical Positions

A person typically takes on ethical positions early in life, due to the influence of family, colleagues, schooling, and religious institutions. There are many ethical positions that a person can take in varying degrees. For example:

- Everyone is entitled to privacy.
- Everyone should be treated fairly.
- One should be honest in dealings with others.
- One should take a course of action that does the least harm to others.
- One should treat others as one would want to be treated.

The exact mix of positions followed will depend on the individual – we do not all possess exactly the same standards. This also means that people may use different approaches to developing a reasoned judgment for how to deal with an ethically challenging situation.

Whatever the mix of ethical positions may be, a person is more likely to follow it when there are clear advantages to doing so. For example, having a strong code of ethics allows a businessperson to enjoy a higher level of customer and employee loyalty and a stronger public reputation, while also reducing the probability of being targeted by lawsuits.

Setting the Baseline

Before evaluating people in regard to their ethical positions, it can be useful to set a baseline for what constitutes an ethical *position*. A person might operate under a set of ethical positions, some of which are stronger than others. Here is a way to define different categories of these positions:

1. *Sacred values*. These values are not to be violated under any circumstances. There will be no trade-offs against these values.
2. *Moral mandates*. These mandates are values that are unique to the individual, relating strongly to the person's sense of personal identity. A person is unlikely to allow a trade-off with other values.
3. *Variable values*. These values are considered of lesser importance, and can be traded off with other values.

Each successive category is less critical to a person than its predecessor, though it is unlikely that the individual would be easily budged from positions taken within either of the first two classifications. It is only in the third classification that people are more likely to shift away from their baseline ethical values.

We now turn to a discussion of how to influence the behavior of employees so that they are encouraged not to deviate from their baseline ethical positions.

The Normative Approach

The normative approach to ethics focuses on what individuals "should" do in order to be morally responsible people. Organizations tend to reinforce this approach by clearly stating what they consider to be the correct behavior. For example, a company could issue an organization code of conduct and review it with all new hires.

A major underlying assumption of the normative approach is that individuals are rational creatures who understand the consequences of their actions. Thus, if a business sets forth a code of conduct, management assumes that employees, being rational, will abide by its dictates. They will, in effect, reach a conscious decision to either act correctly or incorrectly. If they choose to act incorrectly, then they are consciously cheating.

The key problem with the normative approach is the implied assumption that only a few "bad apple" individuals are choosing to behave incorrectly. All others will be reasonable in adhering to the behavioral dictates of the business, which means that only a few people on the far left side of the bell curve of human behavior will cause trouble. However, a wide range of ethical lapses have occurred in organizations that involve people who most definitely are not considered part of that tiny group of "bad" people. An examination of real world ethical lapses reveals that problems may come from anywhere within the employee population, and are not related to a rational examination of correct behavior. For example, an employee engages in unethical behavior and does not even realize the implications of her actions.

EXAMPLE

A person overhears people talking in the elevator about an upcoming merger and decides to buy stock based on this information. Her actions are based on illegal insider information, but she never stops to consider that this is the case.

As another example, a long-term, reliable employee commits a minor indiscretion that gradually grows in size to become a significant case of fraud.

EXAMPLE

The treasurer of a church needs a few dollars to pay off a gambling debt, and takes it from the church petty cash fund. Given the ease with which he was able to draw upon the church's funds to pay for his gambling activities, he begins to gamble with larger amounts, which eventually requires him to steal significant sums from the church in order to settle his debts.

The Intuitive Approach

It is possible that individuals are not making conscious decisions to cheat. Instead, they act intuitively. That is, they automatically react to a situation, rather than thinking through the consequences of the situation. Their reaction is to immediately come to a conclusion regarding a moral judgment without ever going through the more conscious approach of examining the situation, searching for a solution, weighing the options, and arriving at a conclusion. In essence, the intuitive approach assumes that moral judgments can be arrived at very quickly, almost as a reflex once a situation arises. Given the speed with which moral judgments are made, it is likely that there is an immediate emotional response that triggers the outcome, rather than a thinking process (which takes too long).

People are more likely to have an intuitive response to familiar situations, where they have worked through any ethical issues already and can now operate essentially on autopilot. The situation is different in an unfamiliar situation, where a person does not have a ready supply of automatic responses, and so will have to ponder the situation at length.

A person is more likely to arrive at a reasonable ethical outcome when he carefully thinks through a decision, and is less likely to do so when his response is intuitive. Consequently, a reasonable way to trigger more ethically correct decisions is to coach employees to reflect more about their actions before making decisions.

Virtue Ethics

One school of thought claims that correct ethical behavior is based on the character of the individual. If a person scores well in certain areas of virtue, she is more likely to behave in an ethically correct manner. Under this line of reasoning, there are several core virtues that a person may have. They are:

- *Courage*. The individual has the courage to consistently stand up for her convictions.
- *Justice*. The person has a strong sense of fairness.
- *Humanity*. The individual takes actions that are more than fair through acts of kindness and understanding.
- *Temperance*. The person is able control her excesses, especially in regard to the need for material goods.
- *Wisdom*. The person has accumulated experience, knowledge, and good judgment.

Under this line of reasoning, someone possessed of the preceding virtues, either entirely or in part, should be able to consistently make the correct ethical choices.

Some businesses test incoming job candidates for these virtues, under the theory that high-scoring individuals are more likely to engage in ethical behavior.

The Descriptive Approach

The preceding discussions of the different approaches to ethical decision making should make it clear that no single school of thought can explain every ethical lapse. There are just too many reasons why people make poor ethical choices, and there are too many people making those choices. In fact, it appears that almost anyone can make the wrong choice when faced with an ethical issue.

Rather than imposing a single prescriptive approach on employees, an alternative is to engage in case studies and role playing – a descriptive approach. The descriptive approach involves an examination of how people make decisions when they are faced with ethical dilemmas, with an emphasis on the psychological processes underlying the decisions. By reviewing these situations and emphasizing the moral components of decisions, people are more likely to choose the moral path in their day-to-day dealings with others. Further, specific ethical traps can be highlighted in a case study, so that people can recognize and sidestep these issues when they occur.

Here are a number of circumstances that are closely linked to ethical weaknesses in a business environment:

<u>Sales</u>

- Using deceptive advertising
- Engaging in deceptive sales practices
- Bribing other parties in order to generate customer orders
- Overcharging customers for work performed

<u>Products and Production</u>

- Releasing unsafe products to customers
- Allowing an organization's facility to generate pollution that impacts the surrounding area

<u>Employee Relations</u>

- Allowing a dress code that some employees find excessively provocative
- Allowing employees to work in an unsafe workplace environment
- Allowing humor that some employees find offensive
- Engaging in discrimination when hiring and promoting employees
- Paying employees at unequal pay levels
- Engaging in sexual harassment

<u>Other</u>

- Lying or bluffing during negotiations
- Accessing private information to research competitors
- Having conflicts of interest on the job, such as:
    - Owning a supplier
    - Hiring a family member

In each of these cases, the discussion addresses the choice being made. In many cases, the morally correct course of action is apparent, but employees make a different choice based on their needs and desires. The choice made can be influenced in many ways, as described in the following example.

EXAMPLE

An employee is clearly underpaid and is barely able to pay her bills on time. She has been reimbursed by her employer for the cost of a class at the local community college in the amount of $500, which is a significant amount of money for her. The college cancels the course and returns the money to her. It is highly unlikely that she will be caught if she does not return the reimbursement to the employer. Is she more likely to make an incorrect ethical decision and retain the money based on her economic circumstances? Or, what if she had just received a major promotion that improved her economic circumstances? How would being better paid impact her choice?

A further consideration of this situation is whether the employer is laying itself open to more instances of employee theft by underpaying its employees. If it pays a decent wage, is there a reduced temptation for employees to steal assets?

Contextual Factors

The ethical behavior of a person depends to a significant degree upon the context within which she operates. In many organizations, the employee is being placed in an unusually stressful situation which may result in poor ethical choices being made. An employee might not normally be considered to have suspect ethical judgment, and yet is so negatively impacted by her environment that she is more likely to choose poorly.

The situation can also be reversed, to show how a high level of ethical awareness in the workplace acts to reduce the incidents in which employees are tempted to engage in incorrect behavior. The following example illustrates the concept.

EXAMPLE

The president of Hodgson Corporation is Andrew Morton. He is legendary within the company for taking care of employees. He routinely finds rides to work for any employees who cannot afford the trip, writes encouraging notes to the staff, and finds any excuse to pay out small bonuses whenever he sees a job being done unusually well. The entire management team has copied Mr. Morton’s example.

Given the highly supportive context within which people work, it should be no surprise that Hodgson has experienced unusually low inventory loss rates, very low employee sick time, and no instances of fraud.

Despite the preceding example, there are many contextual situations that have a negative impact on decision making, as noted in the following sub-sections.

Imposed Pressure

A relatively common situation is when there is heavy pressure from management to attain certain performance targets, such as doubling profits. In this environment, is an employee more likely to accede to management’s wishes and make suggestions for fraudulently altering the books to manufacture a profit?

A variation on the pressure concept is when the compensation system places undue pressure on the employee. For example, a promotion plan in a CPA firm creates a strong incentive for employees to increase sales, which creates pressure to overbill clients.

Interpersonal Interactions
People are more likely to tell a lie when they are dealing with anger or threats from other parties. In these situations, an individual fears the other party and so is more likely to say anything to get out of the immediate situation. Once a person has told a lie, he has committed an ethical breach and may have difficulty getting out from under it. Instead, the person may continue to lie in order to maintain the initial prevarication. Based on this scenario, it makes sense for management to look for instances in which employees are being unduly pressured, and work to eliminate those situations.

EXAMPLE

A bank's president sets a goal of selling at least six products to every customer. The local bank managers enforce this goal by threatening to fire anyone who does not comply. The obvious outcome is that employees create fake bank accounts for customers and sign them up for additional products without telling the customers. The situation is eventually made public, resulting in massive customer defections and government fines.

Dislike of Managers
A manager may be actively disliked by his subordinates. Is it possible that the manager's subordinates will make improper ethical decisions just to get back at the manager? For example, a salesperson could deliberately annoy a customer in order to lose an order, knowing that this will result in her manager not receiving a quarterly bonus.

Peer Impacts
A person's peer group can have a significant impact on the ethical judgments of an employee. This effect is especially pronounced when there are close and frequent interactions between the employees. For example, when an employee witnesses a close associate stealing from the organization, she is not only less inclined to report the incident, but is also more likely to engage in the same type of theft. In essence, those operating in a close group are more likely to share their values to the detriment of those outside the group.

A person can belong to multiple peer groups within an organization. Each group focuses on a different aspect of peoples' work assignments, culture, beliefs, and so forth. For example, a person might be included in the following groups:

- Employees within the same department
- Employees with similar demographics (such as similar genders or race)
- Employees with the same political orientation
- Employees with the same religious beliefs

Thus, a person can consider herself loyal to multiple groups and so may adopt preferential biases when dealing with people in these groups.

When a company is becoming too homogeneous, there is a significant risk that some of these groups will become so large that their worldviews take over the organization, which can have a major impact on the business – and not necessarily in a good way. For example, if a company starts up with a core group of white male golfers and continues to only hire from this same group, the business will eventually find itself falling into the ethical lapse of excluding all other potential new hires. A reasonable solution to this situation is to actively pursue hiring across a broad demographic, thereby breaking down groups that might otherwise exert an excessive influence on the organization.

Social Bonding Effects

When employees form a close association with their place of work, they are more inclined to support it, which results in fewer ethical issues. This can present a problem as a company grows in headcount, since employees may feel as though they are just an employee number, rather than a person who is valued. The same problem arises when there is a merger or consolidation of facilities, since both actions result in a person being surrounded by a larger number of employees. The problem can also occur when employees work from home or are constantly working in the field, since they never have a chance to interact with others.

It can require a considerable ongoing effort to ensure that social bonding still occurs as an organization increases in size. This can include planned get-togethers, moving employees among different departments, and proactively meeting with people who are not normally in a position to come into the office on a regular basis.

Organizational Structure

Another contextual issue is the organizational structure of the business. In a strongly hierarchical environment where direction comes from the top of the organization, there is pressure for employees to blindly accept the decisions made at the top of the corporate hierarchy, without questioning whether those decisions are correct. In this environment, it can be surprisingly easy for even a small management team to impose decisions on an organization that are ethically suspect, with little pushback.

Conversely, if the business structure is flatter, with decision-making forced down into the organization, employees feel more empowered and so have less reason to make poor choices. There is no pressure to adhere to a single vision being promulgated from the top of the organization.

Perceived Fairness

When an organization has fair procedures and structures, employees are more likely to behave in an ethical manner. When this is not the case, employees will feel that the organization is abusing them, and so will be more inclined to behave in unethical ways.

EXAMPLE

A restaurant chain has laid out a clear path for how to be promoted to the restaurant manager position and then consistently follows through on promoting in accordance with its stated policy. Because of the perceived fairness of this process, employees are less likely to steal from the company. If there had instead been a perceived trend toward promoting based on favoritism or with a bias against minorities, employees might have been more tempted to steal from the organization.

Working Conditions

When there are good working conditions, employees tend to be happier. When an employee is happier, the person tends to be more generous with others, and so is less likely to engage in unethical activities that will hurt others. Conversely, if working conditions are poor, employees think worse of themselves and are more likely to take it out on the employer by engaging in less judicious activities.

Wealth Effects

What if the workplace looks quite wealthy? Perhaps there are original paintings on the walls, massive executive suites, an executive dining room, and so forth. When there is an air of wealth in a work environment, employees are more likely to feel that they are not getting their fair share of this wealth. If so, the resulting sense of envy or indignation can lead to unethical behavior, usually involving the theft of assets. The usual rationalization for this behavior is that the organization can afford the loss.

With this negative effect in mind, management might consider deliberately toning down the appearance of the office and the more conspicuous forms of spending, so that the company appears to have earnings more on a par with other firms – even if this is not really the case.

Summary

The discerning manager will realize that the context within which employees operate can be altered to increase their propensity to engage in ethical behavior. Many employees may enter an organization with one set of traits and then alter those traits so that they mesh more closely with the local environment. Consequently, well-considered changes to a business can improve the ethical decision-making of employees.

Chapter 1 - Review Questions

The review questions accompanying this course are designed to assist you in achieving the course learning objectives. The review section is not graded; do not submit it in place of your qualified assessment. While completing the review questions, it may be helpful to study any unfamiliar terms in the glossary in addition to course content. After completing the review questions, proceed to the review question answers and rationales.

1. The _______ approach to ethics focuses on what individuals should do to be morally responsible.

   a. Virtue ethics
   b. Intuitive
   c. Descriptive
   d. Normative

2. The following contextual condition tends to be imposed by management:

   a. Peer impacts
   b. Social bonding effects
   c. Pressure
   d. Wealth effects

Chapter 2 - Ethical Infrastructure

Learning Objectives

Upon successful completion of this course, participants will be able to:

- Recall the impact on ethics of the different types of organizational structures.
- Note the theories associated with catching improper employee behavior.
- Identify the components of a fair decision making process.
- Recall the characteristics of a leader who is more likely to be followed by employees.
- Identify phrases that may be considered euphemisms.
- Note the effects of blanketing an organization with too many rules.
- Recall some of the rationalizations used when someone commits fraud.

Various structures can be installed within a business that make employees more aware of the ethical practices that management wants to promote. When these structures are routinely placed in front of employees, there is a much greater tendency to follow the entity's stated ethical practices. Examples of this infrastructure are:

- *Present clear expectations*. A code of conduct is included in the employee manual, covered with new employees, and routinely reinforced by messages from management. This code clarifies expected behavior. Further, the board of directors and the management team routinely communicate their expectations, stating clearly what is desirable and undesirable activity.
- *Have role models*. Every person in a supervisory position acts as role model for the employees, showing through their actions the expectations for proper ethical behavior.
- *Set reasonable goals*. When employees are given achievable goals, there is no temptation to break the rules to achieve the goals. Conversely, stretch goals that can only be attained through inappropriate behavior are to be avoided.
- *Respect employees*. When the organization shows a proper level of respect to and interest in its employees, they are much more inclined to treat the business in the same way. In this situation employees are more likely to actively pursue the ethical goals of the business, reporting any lapses to management.
- *Impose penalties*. The penalties that will be imposed on employees who break the code of conduct are clearly laid out in the employee manual. These penalties must be actively enforced, so that employees understand why they must follow the ethical standards set by management. See the comments in the following sub-sections regarding detection theory and the punishment of unethical behavior.
- *Be open to comments*. The structure of the business should allow for open discussions of employee concerns, so that ethical problems can be brought out and debated. The result is usually mutual agreement on how to handle specific situations. See the comments in the following sub-section regarding letting off steam.
- *System of controls*. There is a robust system of controls within the company. These controls are intended to minimize the number of situations in which employees will be tempted to engage in activities to steal from the firm. However, the beneficial effects of a system of controls reverses when there are too many controls. When the system is clogged with controls, it is perceived as being dysfunctional, which may draw reactions from employees to circumvent it.

The last item, the system of controls, is worth additional discussion. When a firm has a large number of controls, with tight oversight of all employee activities, the message being sent to employees is that they are not trusted. When employees feel that this is the case, they are more likely to engage in unethical practices. In effect, they are meeting the expectations of management that they are not to be trusted. This finding conflicts with the increasing mandate for more controls in a business, on the grounds that more controls always result in reduced errors and asset losses. It is possible that a better approach is to concentrate the use of controls in areas where there is a significant risk of major loss, and maintain a lower level of control over other operations. The net effect may be that employees respond to the perceived change in expectations by performing to a higher standard.

Another important item was the presentation of clear expectations. When employees are routinely reminded of the ethical values of the organization, it reminds them to think of the meaning and significance of honesty at the point when they are tempted to make an incorrect decision. By routinely presenting a picture of an honest person to employees, they are more likely to emulate that image.

The ethical infrastructure works best when applied to a younger organization, where no one is accustomed to any other system (or lack thereof). Conversely, when new leadership is hired into an older organization, it has a more difficult time breaking up the existing calcified systems and replacing them with a more robust and ethical infrastructure.

Detection Theory

Detection theory states that the probability of a transgression decreases as the probability of detection goes up. In other words, when a person is contemplating committing an ethical breach, he first takes into account the probability of being caught. If there is a low risk of being found out, then the person is more likely to proceed with his plans.

Clearly, detection theory points us in the direction of creating circumstances in which there is a high probability of detection. For example, we can document all transactions so that there is a clear record of activity, have people work in teams so that someone else can see a transgression, and routinely audit transactions. An excessive number of these controls can make it appear that management does not trust employees, so be prudent in selecting controls.

Punishment of Unethical Behavior

It is not sufficient for management to talk about ethical behavior. It must also have a system in place for punishing anyone who breaks the organization’s code of conduct. Otherwise, employees will realize that the code is empty words and so will have no reason to follow it.

There are a number of possible punishments for an ethical breach, ranging from suspension while an investigation is conducted to termination of employment and even prosecution. Organizations have an unfortunate tendency to gloss over these issues with nothing more than a verbal warning. When this happens, a message is being sent to the entire organization that an ethical lapse is really just a minor issue that has no significant repercussions. The reverse approach of issuing a significant punishment in a timely manner makes it quite clear to everyone that ethical lapses will not be tolerated.

EXAMPLE

As part of a routine audit, a company finds that its sales manager has been stealing money by submitting inflated expense reports. Over several years, this has resulted in overpayments to the sales manager of $50,000. The employer not only fires the sales manager, but also chooses to prosecute to the full extent of the law.

A beneficial side effect of prosecution is that other employees see how the company reacts to being defrauded. Because the sales manager is being pursued vigorously in court, employees understand that there is a greatly reduced opportunity for fraud within the company, and so will be less inclined to engage in it. Further, when the company pursues restitution for the amounts stolen, this reduces the perceived gain that others might see from engaging in fraud.

The punishment level for fired employees can be enhanced by maintaining an ineligible for rehire list. This list is maintained by the human resources department and prevents someone from being rehired by any subsidiary of the company – ever. As soon as a person is fired for an ethical breach, they are entered on the list. All subsequent job candidates are matched against the list before they can be hired.

Letting off Steam

A business may be going through a difficult time, in which case it is necessary to lay off staff or cut pay. In this type of situation, employees are more likely to steal assets from the business to show their frustration. Management can mitigate the amount of asset theft by allowing employees to blow off steam – usually by spending a large amount of time explaining the situation to them and spending yet more time to answer any questions posed by employees. If management instead simply informs employees of the situation without allowing them an avenue for letting off steam, there is a strong risk that theft levels will increase.

Fairness of the Decision Making Process

Employees are much more likely to act in an ethical manner when they feel they are being treated fairly in the decision making processes of the organization. When there is a fair process, employees are more likely to accept its outcome, especially when they have input into the process and they understand the reasoning behind the outcome. A fair decision making process has the following components:

1. Employees can give input before a decision is made.
2. The rules for making decisions are clearly laid out and logical.
3. The persons making decisions have a history of doing so based on objective information and appropriate decision criteria, instead of their personal biases.
4. The decision making process is applied consistently over time.
5. Decisions are communicated politely, taking into consideration the feelings of the recipient.
6. When decisions are made, the persons making the decisions state how they arrived at the outcome. Better yet, the organization periodically highlights the consistency in decision making to show that bias does not exist.

When employees are treated with the dignity and respect inherent in the preceding ideal decision making process, it should be no surprise that they are much more likely to respect and admire the management team, which makes it easier for leaders to require a high level of ethical behavior from their staff.

The Role of Leaders

The leaders of a business can have a profound impact on the ethical behavior of employees. A leader should routinely demonstrate the best possible behavior through his actions and promote this conduct through personal communications with the staff, general corporate communications, and the general example given by his actions. The ideal leader is seen as being honest and principled, making fair decisions, setting a high ethical standard, and working to show subordinates the implications of their own decision making. The last point is of particular importance. The ideal leader is a counselor, helping employees work through their own decision making processes.

When a leader is respected and admired by employees, they are more likely to emulate the person's behavior. This means they will copy the leader's decision making processes, while also avoiding counterproductive work behaviors of which they do not believe the leader would approve. Thus, a leader can exercise an inordinate amount of influence over an organization by molding the thinking of employees.

Molding the thinking of employees does not mean that the management team can (or should) attempt to alter the moral values of employees. Most people have a strong idea of what is right and wrong already, and will not alter their perceptions just based on a mandate from the company president. However, management can coach employees in the decision making processes that can be used to arrive at a reasonable decision. Employees then use their existing moral values to evaluate situations.

A leader is not necessarily just the person granted the title of chief executive officer. There may be many other leaders within an organization, some without any identification as such on the corporate organization chart. These informal leaders may have gained some degree of authority due to their social skills or experience; as such, they can have a profound effect on the ethical behavior of employees. Given their outsized influence, the senior managers of a business should be aware of who these people are and make a strong effort to counsel them regarding ethical decision making. Focusing on this group of leaders gives senior management an unusually strong level of influence over the organization as a whole.

An interesting variation on the concept of leadership is that employees are more likely to follow a leader when the leader already conforms to their expectations for how a leader should behave. If a leader departs from these expectations, employees may begin to doubt the person's authority and influence. When this happens, the leader's ethical influence on the organization is diminished. It is even possible that the leader will alter his behavior in order to meet employee expectations, which can alter the example he sets in regard to proper ethical decision making.

In a situation where management elects to follow a course that employees believe to be ethically incorrect, employees are more likely to undermine management's efforts and will certainly not go out of their way to be of assistance. Thus, there needs to be a significant amount of overlap between the ethics of the management team and the employees in order to arrive at a reasonable working relationship between the two parties.

When leaders are routinely promoted from the employee ranks, these individuals have been steeped in the behavioral norms of the employees, and so are likely to continue to apply those norms as leaders. This is fine when an organization already has high moral standards, since those people who have been internally promoted will likely perpetuate the current situation. However, if the organization does not have a highly ethical culture, a habit of promoting from within is more likely to maintain the status quo – each iteration of corporation leadership is just the same as the group it is replacing.

The Effect of Unethical Leaders

It can be instructive to look at the effect of leadership when there is an unethical person in a position of authority. Employees have a tendency to follow orders, even when those orders are clearly wrong, so when an unprincipled person is issuing orders, there is a possibility that those orders will be carried out – even if employees consider the orders to be reprehensible. The reason is that the employees do not feel responsible for the action because they are not the ones who initiated it. Also, they may feel that protesting will put them at risk of being fired.

This effect is especially pronounced when the person has a strong aura of authority. This aura can be conveyed when a person has a large amount of experience, a very senior title, a doctorate, dresses well, and so forth. Consequently, there is a serious risk that just a few of these “bad apples” within an organization could cause widespread ethical lapses.
A reasonable way to minimize the effect of these leaders is to tell employees that it is quite acceptable to question dubious orders, without fear of consequences. This approach will only work if there is a method in place to route information to an ethics office, so that the board of directors is made aware of situations in which managers are causing problems.

Signs of an Unethical Leader

What are the indicators of an unethical leader? One indicator is that the person is more aggressive, continually snapping at and belittling subordinates. This is an indicator because the person is clearly showing that he does not want any discussion – he only wants to be obeyed. And, because the dictatorial signal is being sent so clearly, employees are more likely to obey his demands. Further, those employees more likely to make a stand will probably be forced out, leaving a group of employees sufficiently cowed by the leader’s behavior to implement whatever demand is made.

Another indicator of an unethical leader is someone who consistently violates the rules that are applied to other employees. For example, a company president prohibits the charging of personal expenses on expense reports and then proceeds to do so himself. Or, the president advocates a strong nepotism policy and then hires family members into key positions. This type of person places himself above the rules that apply to others, and so is much more likely to engage in ethical lapses on a recurring basis.

Employee Interaction with Management

We have just noted that employee expectations can influence how leaders behave. Employees can interact with management in other ways, as well. For example, if a manager is engaged in behavior that is ethically incorrect or operates within a gray area, employees can challenge the person regarding his actions. This approach is a rare one, given the power that managers can exert over employees. Usually, only the more senior employees or those with long-term relations with managers are willing to challenge them.

A variation on challenging managers is to never give managers the opportunity to make a choice. Instead, employees present managers with situations that exclude any possibility of making an ethically challenging decision.

EXAMPLE

A company owes $10,000 to a supplier. The payables clerk hears that the supplier's facility has been burned down and all records lost. Because of the catastrophe, the supplier's owners have decided to declare bankruptcy. Because of the loss of records, the company could probably get away with not paying the $10,000, and no one would ever know. Rather than presenting this option to the company controller, the clerk elects to just pay the invoice, which is the correct ethical decision. The controller never has to make a decision, since he never finds out about the issue.

An alternative approach is to guide the thinking of managers. For example, an employee can have a discussion with a manager to talk about the outcomes of certain behavior in an attempt to redirect the manager's activities in a somewhat different direction. This approach is less confrontational and so has a greater chance of success. Again, only the more senior employees or those connected with managers will have much success in this area.
In the latter case, an employee could act as a role model for a manager. As such, the person is exhibiting correct ethical behavior, showing that a certain approach is feasible. The hope is that the manager will copy the employee's behavior. A variation on the concept is when an employee models the ethical behavior that a leader is proposing, to show the leader the outcome of the proposed change. By doing so, the leader can see how the proposed change would work, as well as any ramifications.

EXAMPLE

The president of a company is working on a new code of ethics and decides to work through the changes with his sales manager. One of the changes is to not allow the sales force to offer anything to customers that could possibly be misconstrued as a bribe – including tickets to the local football game, where the company has a season pass. To model the change, the sales manager prevents one salesperson from offering the tickets to his customers and gets immediate negative feedback from them, who have come to rely upon the company's excellent seats in the football stadium.

This feedback convinces the president to be more permissive with the use of certain perks when dealing with customers.

An alternative way for an employee to act as a decision guide is to keep providing a manager with information related to a decision, as well as interpretations of the information, to guide the manager away from an incorrect decision. This approach is available to all employees, irrespective of their level of seniority, as long as they have relevant information and opinions to contribute.

When interacting with management over ethical issues, there is a significant risk that an employee will damage the working relationship with a manager by too aggressively attacking the manager's position. Consequently, many employees take the lower-risk approach of guiding the thinking of managers or of never bringing up issues at all.

Thus far, we have placed the employee in a reactive mode, responding to ethical issues raised by a leader, presumably someone within the management team. It is possible for employees to turn around the situation and present management with a proposed change to the ethical position of the business. Otherwise, a management team that has little interest in the ethical position of the firm will likely leave that position in place for the foreseeable future, which can be frustrating to employees.

EXAMPLE

A chain of small-footprint hardware stores has historically expanded by adding locations in areas where customers have a high net worth. This strategy has worked well in the past, since the customer base is willing to spend inordinate amounts on their home maintenance activities. Several employees approach the management committee with a suggestion to add stores in very low income areas. Doing so would require a reconfiguration of the inventory kept on hand, and presents the risks associated with any new initiative. However, the proposal would result in the hiring of low-income people from these areas, thereby injecting money into economies that are in great need of the cash infusion. In addition, the change in store locations opens up a new market niche that is not being exploited by any competitors.

A proposed ethical change can impact the strategic or tactical position of a business, and so can be an important initiative – as noted in the preceding example.

Employees can also have a role in making management aware of ethical implications. When a business engages in an action or neglects to take action, this can have an ethical impact that may not be considered by management at all – perhaps because the issue has not had an ethical implication in the past. Since employees operate closer to the daily activities of a business than managers, they are in a better position to spot these problems.

EXAMPLE

A company operates a social media site that is targeted at people interested in home repairs. Thus far, the site has required users to state their full names as their user identifications. Management is considering a change to anonymous names. The information technology staff has been monitoring a related social media site that allows anonymous names, and has seen a spike in the number of trolls making inappropriate comments on the site. They point out the issue to the management team, which promptly drops the anonymous naming idea.

Employees can be especially useful when a new manager is hired from the outside, rather than being promoted from within. This person is not aware of why the company takes certain ethical positions, so the more experienced employees can provide her with stories about past situations that caused those positions to be taken. By doing so, the new hire builds up a base of information that supports the current ethical posture of the organization.

Employees may be able to gain the interest of management in regard to an ethical issue if they frame the problem in a way that connects with the decision makers. For example, if the company president has a daughter, he might be more inclined to listen to an appeal to adjust any disparities between the pay of male and female employees.

The preceding points should make it clear that employees have an opportunity to play a significant role in formulating and maintaining the ethical posture of a business. Thus, the establishment of ethical positions should not be limited to the management team.

Why Employees Violate Their Own Ethical Standards

Employees have a set of ethical standards that they developed early in life and have followed to the present day. And yet, they sometimes violate their own ethical standards. How can this happen? One reason is that they convince themselves that they are not actually violating an ethical standard. This can be accomplished in several ways. For example:

- They position themselves so that they are not the ones being forced to make an unethical decision. For example, the manager of a brokerage sets sales goals for the stockbrokers that are so difficult to attain that the employees would have to engage in additional unauthorized trades with client funds in order to achieve the goals.
- The unethical action is handled by an intermediary. For example, a company outsources an entire department to a third party, which then cuts the pay of those remaining employees who now work for the third party.
- The person hands off responsibility. For example, a sales manager hears that a new baby seat product has a flaw, which will require a product recall. He chooses to continue selling the baby seat, thereby generating commissions, while waiting for the company president to halt sales at a later date.
- The person delays making a decision until more information is available. For example, a mine owner encounters a case where a mine employee is suffering from black lung disease. Rather than immediately acting to improve the mine ventilation, he commissions a study that delays the decision for a year. Thus, the person reasons that an ambiguous situation provides him with ethical immunity.

By dealing with situations in this way, they do not have to face the consequences of their actions, resulting in a façade of ethical behavior that is not really the case. In essence, a person does not feel as morally accountable when someone else is doing the dirty work.

Another way in which a person can violate his own ethical standards is to persuade himself that the decision being made is not unethical, such as choosing to believe in those moral values that most favor him. For example, a manager making a budget request for pay increases in the upcoming year may request a larger pay boost for himself, using the principal that he works longer hours or has a greater impact on the results generated by the department. If the manager had instead believed in the equitable distribution of compensation, he would have requested a smaller amount for himself.

EXAMPLE

A procurement manager worked his way through college, taking an extra two years to do so because of the amount of work required to pay for tuition and housing. Later in life, a supplier offers the manager a modest gift. The manager accepts the gift, using as an excuse that it is a reward for his years of hard work in order to arrive at his current position.

EXAMPLE

A company president elects to not install pollution controls on his manufacturing facility, on the grounds that he has a responsibility to generate the highest possible profit for the shareholders of the business.

It is also possible that employees will morally disengage on those ethical issues that they have violated in the past, why still maintaining ethical standards in other areas. By doing so, they believe that they are still meeting their own standards, even though the standards now have holes in them.

EXAMPLE

An employee accidentally adds one hour of overtime to his weekly timesheet and later finds that his employer paid the overtime. Thereafter, the employee consistently adds a small amount of overtime to his timesheets. He mentally blocks the ethical problem with stealing money from his employer in this manner.

The manipulation and reasoning shifts that a person can go through in order to justify a questionable ethical position indicates a certain amount of psychological complexity – a person does not simply make a hard, black-and-white choice to engage in questionable behavior. What people appear to be searching for is situations in which it is possible to behave in a less than ethical manner without feeling that they have done so. In the following sub-sections, we point out additional situations that can result in incorrect decision making by employees.

Euphemisms

A euphemism is the substitution of a vague term for one that is considered to be harsh or blunt. For example, the accounting staff can be committing financial statement fraud by deliberately altering the ending inventory balance, but refers to this activity as “earnings management.” When a euphemism is used, the effect of the underlying activity does not appear to be that bad, so employees are more likely to continue in the activity. Similarly, bullying in the work place is described as “joking around,” which sounds far less troubling. In short, the use of euphemisms tends to blind employees to what they are doing, or at least reduces its perceived seriousness.

Whenever a euphemism is in common use within an organization, this is an indicator of a recurring situation in which an ethical problem is not being viewed as such by employees.

Antisocial Behavior

An organization may have a group habit of engaging in certain types of antisocial behavior, such as bullying and hostility toward minorities. If management were to allow this clearly negative activity, it would be difficult to halt the unethical behavior at just these activities. Instead, the effects of antisocial behavior tend to spread. The reason is that employees see this behavior going unchecked and assume that other types of negative behavior will also go unpunished.

When there are especially abusive behavioral situations occurring on an ongoing basis, employees are even more likely to discount any code of conduct that may have been promulgated by management, on the grounds that it is clearly not being enforced. In this situation, employee values have been so deeply perverted that it takes a major effort to restore an ethical environment.
Given the severity of pervasive antisocial behavior, it is critical to vigorously intervene whenever one of these situations arises, so that the malaise does not spread further.

Time Pressure
Forcing employees to achieve too much within too short a period of time can cause any number of ethical problems. When faced with a short deadline, employees are more likely to skip important tasks, lie about having completed them, or eliminate steps that might have a major negative impact on the outcome.

Time pressure occurs when management has set goals at such a high level that there are not enough hours in the day to achieve them. It is also possible that the capacity of the organization is not sufficient, so that too few people are available to work on goals. The latter situation is especially common in a corporate turnaround, where management has been forced to cut staff in order to save money, but still demands the same total performance from the remaining employees.

A reasonable way to mitigate the effects of time pressure is to incorporate a modest amount of slack time into the work schedule. This time allocation is intended as a reserve to deal with unexpected problems or interruptions. Sometimes this reserve will be used, and sometimes it will not. In cases where the reserve is not used, the time is still available for discussions about ways to improve productivity, which further minimizes time pressure. An additional action to take is to reduce the goals being imposed on employees. When slack time is combined with goal reductions, it is possible to largely eliminate time pressure on employees, thereby putting a stop to any ethical lapses that might otherwise have arisen.

The Crowding-Out Effect
Management might consider it useful to impose a penalty on employees, with the intent of stopping certain behaviors. For example, someone being caught removing office supplies from the premises is fined $10. The problem with imposing these penalties is that they supplant any moral obligation that a person might otherwise have felt to not engage in the activity. Instead, the moral obligation is crowded out by the economic consideration imposed by the penalty. To return to the example, a person might decide that the benefits to be gained from stealing office supplies is greater than the potential $10 penalty, and so will continue to steal supplies. If the penalty had not been imposed, it is likely that the amount of office supplies theft would be lower, because of the force of the moral obligation to not steal.

In short, it is not always a good idea to impose penalties in order to alter employee behavior; the opposite effect might occur.

Goal Sickness

Goal sickness (also known as tunnel vision) occurs when employees focus so hard on a goal that they literally do not see the side effects of the actions taken to achieve that goal. This can cause many ethical lapses, such as:

- Not conducting safety tests on a new consumer product in order to meet a product launch date.
- Selling unnecessary product warranties to customers without telling them, in order to achieve a sales goal.
- Using substandard materials to construct a custom product for a customer, in order to achieve a profit target for the job.

The key negative perception arising from goal sickness is that the ends justify the means; employees will do anything to ensure that the goal is reached. The severity of this issue can be minimized if management continually inspects the activities leading up to the goal, questioning the appropriateness of the actions taken to achieve the goal. Unfortunately, some managers are so focused on the goal that it does not occur to them to engage in this monitoring activity.

A variation on goal sickness is the prevalence of cheating when a person is close to a goal, but is likely to fall short of it. In this case, there is a strong temptation to cheat in order to bridge the performance gap. This is especially the case when the performance gap is quite small, since the quantified amount of the cheating only needs to be a small amount. For example, when the financial statements of a publicly-held company are only $0.01 of earnings per share short of the expected earnings level, there can be quite a scramble in the accounting department to make up the difference.

EXAMPLE

A sales manager sets up a sales plan that rewards the winning salesperson with a free trip to Tahiti. Everyone else receives no reward at all, no matter how well they perform. The inevitable result of this plan is a mad scramble by the sales staff to obtain customer orders by any means, including bribery, as well as pressure on the shipping department to classify shipments as having been within the reward period, even when the shipments were made at a later date.

After reviewing the unfortunate outcome of this sales plan, the sales manager decides to offer a different plan in the next period that offers a more equitable amount of rewards to a large proportion of the sales staff. The unethical behavior promptly vanishes.

A more subtle form of goal sickness arises when an organization measures too *many* things. When employees are overwhelmed with a multitude of goals and measurement systems, they do not have a clear understanding of which goals are the most important, and so will pick which ones they feel are the most achievable. All other goals are given little or no attention. At the end of the measurement period, the outcome will be an odd mix of wins and outright failures, where the more important goals may not have been touched at all.

Another variation on goal sickness occurs when employees meet a goal and promptly stop working beyond that point. For example, a salesperson meets his quarterly sales quota and then stops selling, or a warehouse person meets his monthly goal of 80% inventory record accuracy and then stops trying to improve the accuracy to a higher level. This situation arises under either of the following circumstances:

- The goal is not set up to reward additional performance beyond the stated reward level; or
- Employees know that the baseline performance level in the next period will be set at the amount achieved in the current period, so they do not want to achieve too high a performance level.

These negative effects can be remedied by setting goals on a sliding scale, so that some reward is doled out to match the actual level attained. Also, a goal should be considered just one target in a long series of targets, so that the achievement of the first goal merely provides a point at which to pause and consider how to move on to a more difficult goal. This means that a goal is not an end in itself, but rather a milestone on a long-term path of improvement.

Finally, the direst form of goal sickness occurs when goals are set at extremely high levels. When a goal is clearly beyond reach and especially when the historical trend of results clearly does not support the goal, employees are forced to look far outside of the normal avenues to achieve the goal. This almost certainly results in fraud, since there is simply no other way to achieve the goal than to fake the results.

The Waterbed Effect

The managers of a business may be tempted to impose a blizzard of rules on employees in order to squash all possibility of unethical behavior - as long as employees follow the rules, everything will be fine. The reality is somewhat different. Employees need some freedom of expression, so when there are too many rules, there is an increased probability that ethical lapses will occur elsewhere. This is the waterbed effect, where pressing down on a waterbed in one place causes it to raise somewhere else. Similarly, imposing too many rules triggers a revolt that causes problems elsewhere.

A side effect of having too many rules is that employees may arrive at the false conclusion that the absence of a rule allows them to do anything at all. In this situation, there may be a large number of minor ethical issues occurring all the time, which managers are constantly trying to detect and eliminate. Further, because of the emphasis on imposing rules, the attitude of the management team is that employees must be closely governed, while the attitude of employees becomes that of rebellious teenagers, looking for a way to strike back.

To avoid the waterbed effect, managers must be cognizant of the risk of imposing too many rules and instead limit the number imposed. A possible way to do so is to set a maximum number of rules that will be used within the organization (such as a code of conduct that cannot exceed one page). If a rule must be added, then see if an existing rule can be eliminated, thereby keeping the total number of rules at a constant (and relatively low) level.

Group Effects

The ethical position of an organization is not set by a single individual, though someone in a position of authority can certainly impose a notable amount of influence on the situation. The reality in most organizations is that many people accept the moral posture of the business and thereby acquire a certain amount of individual moral responsibility for the actions of others within the firm. This is because the actions of the entire group form the culture of the business. Each person in the group supports and facilitates the actions of everyone else, thereby making each person complicit in the actions of the group.

This negative group effect can also refer to the inaction of the members of a group. For example, if several people in a group see an ethical lapse and yet refuse to act, they are tacitly approving of the lapse through their inaction.

A consequence of the group effect on behavioral ethics is that an investigation of an ethical breach should take into account the entire group within which the most responsible person was situated. It is entirely possible that the whole group is to blame to some extent, so remedial action should take everyone into account. For example, firing someone committing fraud is not enough – remedial action may need to be taken for that person's entire department.

EXAMPLE

A bank's management team formulates a new product that provides overdraft protection to the holders of checking accounts in exchange for an exceedingly large transaction fee and a high interest rate on the overdraft amount. This fee structure violates the law in several states where the bank has customers, and yet the management team still rolls out the product.

Both the management team and the bank's legal compliance department have certain knowledge of the legal breach, as do the branch managers in the states where the law is being broken. Any person in this group can be considered culpable, having not taken action despite a clear legal and ethical breach.

A further concern is that the culture of the bank is clearly focused on turning a profit, rather than focusing on the best interests of its customers. Too much attention to profits means that price gouging makes sense, whereas a focus on the customer would have immediately terminated any discussion of overpricing the overdraft protection product.

Whistleblowing

Whistleblowing occurs when someone in an organization discloses wrongdoing within the business to an outsider. Whistleblowing typically occurs when an employee has already tried to bring an issue to the attention of management and has been ignored or had her concerns downplayed. The individual is frustrated by the lack of attention to the perceived problem, and so feels forced to go outside of the organization for resolution. This situation most commonly arises in a command-and-control environment where authority is centralized with a small group of managers. If this group does not choose to listen to complaints from employees, the employees have no other outlet than to engage in whistleblowing. Alternatively, when an organization is managed based on a code of conduct and employee empowerment, employees are less likely to be stymied when reporting ethical issues, which results in a significant decline in whistleblowing.

Whistleblowing is an extremely risky endeavor for an employee, since the person is completely sidestepping the organization's chain of command. Likely outcomes of whistleblowing are being excluded from further promotions, a downgrade into a lesser position, or even being fired.

Chapter 2 Section 1 - Review Questions

The review questions accompanying this course are designed to assist you in achieving the course learning objectives. The review section is not graded; do not submit it in place of your qualified assessment. While completing the review questions, it may be helpful to study any unfamiliar terms in the glossary in addition to course content. After completing the review questions, proceed to the review question answers and rationales.

3. A reasonable ethical infrastructure should have the following elements, **EXCEPT** for:

   a. Set stretch goals
   b. Have role models
   c. Present clear expectations
   d. Impose penalties

4. The following is a step a person might take who is convincing himself that he is not actually violating an ethical standard:

   a. Stretch goals are imposed on lower-level employees
   b. Outsourced functions are brought back in-house
   c. Make a decision based on the information currently at hand
   d. Accept responsibility for a decision

Fraud Triggers

Fraud is a false representation of the facts, typically in order to achieve personal gain. Under what conditions does someone commit fraud? There are three interlocking conditions, known as the *fraud triangle*, under which fraud is most likely to flourish. These conditions are:

- *Perceived pressure*. A person may be liable for significant liabilities, such as the cost of supporting sick relatives, college loans, car loans, and so forth. Or, they may have an expensive habit that requires ongoing funding. When the individual sees no way out of the situation, they may resort to fraud. However, there may only be a *perceived* level of pressure, such as earning comparatively less than one's friends. This latter situation can trigger expectations for a better lifestyle, perhaps involving a sports car, foreign travel, or a larger house. When a person does not see a clear path to meeting these expectations by honest means, he or she may resort to dishonest alternatives.
- *Opportunity*. When the preceding pressures are present, a person must also see an opportunity to commit fraud. For example, a maintenance worker may realize that there are no controls over checking out and returning tools; this is an opportunity for theft.
- *Rationalization*. An additional issue that is needed for fraud to continue over a period of time is the ability of the perpetrator to rationalize the situation as being acceptable. For example, a person stealing from a company's petty cash box might rationalize it as merely borrowing, with the intent of paying back the funds at a later date. As another example, a management team adjusts reported earnings for a few months during mid-year, in the expectation that sales will rise towards the end of the year, allowing them to eliminate the adjustments by year-end.

The issues noted here tend to interact. For example, if a person is under an intense amount of financial pressure and there is a serious opportunity for fraud, then the level of rationalization needed to justify committing fraud will be quite low. Conversely, if there is little pressure and only a modest opportunity to do so, then it will take a much higher level of rationalization to justify the fraud. Consequently, a good approach to proactively dealing with fraud is to work on all of these areas – reducing the financial pressure on employees and minimizing the number and size of opportunities for fraud.

We cover the pressure, opportunity, and rationalization issues in more detail in the following sub-sections.

Perceived Pressure

The most obvious type of pressure that may impact a person is financial pressure. While one might associate real financial pressure with someone living in a car or under a bridge, anyone can have a perceived amount of financial pressure even when they already earn a substantial amount of money. Consider the following situations:

- A person is living well beyond his means. For example, a production worker loves sports cars and is determined to have one, even though his hourly wage does not begin to qualify him for a car loan. Or, a corporate executive wants a private jet, so he will misrepresent his company's profits in order to sell shares at a higher price and then buy the jet.

- A person has incurred a large amount of debt. His current wage might have been sufficient under all normal circumstances, but the additional amount of debt payments renders his situation much less tenable. The same situation arises when a person's wages are being garnished.
- A person is suddenly confronted with a large expenditure. For example, a person's spouse is uninsured, and she must now undergo expensive radiation therapy to treat cancer.
- A person wants to be perceived as being successful. This calls for the acquisition of a large home, a cabin in the country, a fishing boat, and other toys. This person is more concerned with the image being conveyed than having a low level of integrity.

Financial pressure can extend to a management team when they are trying to protect the viability of their company. For example, an entity's financial results have been gradually declining, and it is in danger of breaching its loan covenants, which will trigger a loan call by the bank. To avoid this situation, the management team adjusts the financial statements to keep the entity's reported results just higher than the thresholds stated in the loan covenants.
A type of behavior that can cause financial problems is any type of vice. For example, a person may be unable to stop gambling and racks up enormous gambling debts. Or, an individual is addicted to hard drugs and is always in need of cash to fund the habit. As another example, a person has a mistress and needs to support her lifestyle.

A different type of pressure is the desire to get even with an employer. For example, a person might have been denied a promotion, and so elects to commit fraud in order to make the employer "pay" for this decision. A person might feel the same way if he perceives his compensation to be unusually low, or if his contributions to the business have not been acknowledged.

Opportunity
A key factor contributing to fraud is the presence of a perceived opportunity to steal assets. These opportunities can come in many shapes and sizes. The opportunity for fraud is certainly enhanced when the environment within an organization is permissive, as would be the case in the following situations:

- *Absence of controls*. A key control might be missing that would otherwise prevent a theft from occurring, or at least detect it after the fact. This situation is more likely to arise when new systems are installed or existing ones are modified without paying attention to the underlying controls. In addition, a business that is not audited is less likely to have an independent review of its system of controls, and so may have no idea that it is lacking a key control. When any of the following types of controls are missing, it represents an opportunity for fraud to occur:
    - The presence of authorizations for transactions, so that a manager must issue an approval before a transaction can be completed, or employees are only authorized to engage in transactions up to a certain dollar limit.
    - Segregation of duties, so that it would require more than one person to commit fraud.

    - Independent reviews of a person's work, perhaps involving job rotations or supervisory reviews, so that a person could not keep up a fraud for a long period of time.
    - Controls over physical access to assets, so that someone would need to break into a controlled area in order to steal assets.
    - Proper supporting documentation for records, to identify the nature of a transaction and any related authorizations.

- *Accountability*. The level of accountability for all tasks should be quite clear within a business. When this is not the case, controls are significantly weaker, since no one is required to engage in preventive or detective activities.
- *Internal audit*. When there is an active internal audit department that is visibly examining transactions, this presents a significant deterrent. When there is no such group within a business, employees are more likely to engage in fraud, since there is no one in an oversight role.
- *Transitions*. Whenever there are layoffs, spin-offs, mergers, and plant closures, there is an increased risk that the control environment will break down, frequently because the key employees with a deep knowledge of controls are no longer working for the company.
- *Vetting practices*. The human resources department must spend the time to research the backgrounds of all job candidates prior to hiring them. Otherwise, people with criminal backgrounds, questionable performances at prior employers, or falsified resumes will be hired, which leads to a higher incidence of fraud.

Rationalization

Someone committing fraud almost always needs to have some way to rationalize this conduct. There are many possible rationalizations, such as:

- I am taking the money from a corrupt organization
- I am using the money to help others
- The organization should have paid me this money
- This is only borrowing for a short time, and I will pay it back
- We will correct the books once we get through this rough patch and sales increase
- I have already paid enough income taxes
- If I pay more income taxes, the government will waste it anyways

With these kinds of rationalizations, a person can lie to himself that there is a good reason for engaging in fraud.

Fraud Addiction

As we have just noted, a person is likely to be under a certain amount of pressure when committing fraud. What if that pressure goes away because the person collects enough money through the fraud scheme? At this point one might think that the person would stop. Instead, the reverse occurs. Frauds tend to become larger over time, because the act of committing fraud can be addictive. A person might succeed with one fraud and then chooses to expand the amount stolen or engage in a series of other frauds. The eventual result is the collection of a great deal more money.

When a fraud investigator finds a fraud situation, it makes sense to assume that the individual responsible for it has not been engaged in just the fraud that was found. That might be a small percentage of the total. Instead, the investigator should not only assume that the same fraud has been perpetrated multiple times, but also that the same person has spread his activities into other areas. The end result may be that the discovery of a small initial fraud balloons into something much larger.

Lying during Negotiations

We finish this course with a discussion of one specific area where ethical standards are routinely put at risk – the negotiating table. Rather than concentrating on the reasons for lying during negotiations, we will focus on the detection and prevention of situations in which lying may occur.

Negotiators routinely incorporate lies into their negotiation strategies. Or, they lie by omission, not stating pertinent facts. They do so in order to gain what they perceive to be an advantage. This is especially useful for them when a lie meshes with the assumptions of the other party. For example, a supplier knows that the company needs to have deliveries within two days of issuing an order, and falsely promises to do so in order to gain the business.

It is extremely difficult to spot when someone is telling a lie. Instead, it is better to devise ways to encourage the other person not to lie in the first place, or at least find ways to reliably detect lies. Here are several ways to do so:

- Appear well-prepared at the start of and throughout the negotiations. This means taking notes and referring back to them, speaking intelligently about all negotiation topics, and indicating a deep knowledge of the industry. In this situation, the other party is more likely to believe that you will detect any lies and so will be less likely to prevaricate.
- Open up about certain types of information early in the negotiations. By doing so, the other person may feel compelled to also provide information, thereby also being transparent and less likely to provide false or misleading information.
- Ask tightly framed questions that have a pessimistic slant. By doing so, the other party would have to deliberately lie to get out of the question. For example, ask “sales are going down in this region, right?” In short, people are less inclined to negate a true statement than to agree with an untrue statement.
- Have a written list of questions to ask and make sure that each question has been answered fully. Otherwise, the other person may lie by answering only part of the question or by sidestepping it entirely.
- Ask for a penalty clause that impacts the other party if it cannot deliver on key aspects of a deal. If the other party pushes back at this, it can indicate that he is lying regarding the capabilities of his company.
- Set a trap for the other party, where you already know the answer and the other party has an incentive to lie. For example, ask the seller of a product if the price he is quoting is the best price he offers everyone. If you have already made inquiries and know the best price, then any higher price quoted by the other party reveals his deception.
- Propose a contingency clause for the contract, where the company pays if the other party’s claim turns out to be correct, and the other party pays if the claim turns out not to

be correct. The other party should agree to this clause if it is telling the truth, and will not agree if its claims are false. The following example illustrates the concept.

EXAMPLE

A corporate buyer is negotiating with a new supplier, which wants to deliver component parts to be used in the company's production process. The company uses a just-in-time production system and so needs to have components delivered to its production line on a daily basis. The supplier claims that it can reliably make these deliveries. However, the buyer is not so sure and so proposes a contingency clause where the company pays extra for timely deliveries, but the supplier accepts a lower price if it does not deliver on time. The supplier then backs down from its earlier claim and instead states that it can deliver with a two-day lead time.

Yet another variation is to incorporate a detected lie into the negotiations, so that it is used as an opportunity to improve the company's bargaining position. For example, a negotiator catches the other side in a lie when he knows that they sell a product for $12.00, and yet are offering their "best" price to him at $15.00. The negotiator could make a statement such as the following:

> "You stated that your best price for this product is $15.00. We have worked with suppliers in this industry for many years, so we know when someone is quoting inflated prices. In this case, we know that your company has been selling this product to other customers for $12.00. We have been trying to negotiate in good faith with you, but now we're concerned about the way in which you are treating us. Of course, there may be a simple explanation for your quote – perhaps you were misinformed by your sales department. Nonetheless, I must point out that the negotiations thus far have been disappointing. Can you help us understand what is going on? Is there a way for us to move forward?"

The preceding statement makes it quite clear that the other party has been caught in a lie, while still offering a way for the person to keep from losing face (he may have been misinformed by his sales department). The tone of the statement makes it clear that the lie is being taken seriously, but does not indicate that negotiations will stop. However, the structure of the statement points in the direction of requiring the other party to make a concession in order to make up for its bad behavior.

If it appears that the other party is either lying about certain capabilities or is at least shading the truth in its favor, this does not automatically mean that you should walk away from the negotiations. Consider structuring a deal so that its scope is quite narrow at first, thereby allowing you to decide whether the other party is capable of meeting its commitments before expanding the scope of the deal.

EXAMPLE

The buyer for a chain of retail stores is in negotiations with a shoe supplier. The buyer suspects that the supplier is not being entirely honest about its ability to ship goods on time. However, the supplier produces fashion-forward shoe designs, so the buyer wants to see if a relationship might work out. To hedge his bets, the buyer agrees to buy a single line of sneakers from the supplier for the first six months, with additional orders of other product lines contingent upon the supplier's ability to deliver on a timely basis.

Our point in discussing these detection and prevention measures is to point out the multitude of ways in which a firm can deal with those parts of a business in which lying is likely to be more common.

Summary

Behavioral ethics impacts an organization in a number of ways. First, knowledge of ethics-based discussions can be used to reason one's way to a desirable outcome that has the least negative effects on the business. Second, drawing the attention of employees to moral standards can greatly reduce their ethical lapses. Third, the environment in which a person is placed has a profound impact on her ethical reasoning, so a manager should be aware of how the business itself is impacting employees. And finally, the ethically aware person is more likely to consider ethical capabilities when deciding whether to do business with others, such as in regard to hiring someone or awarding business to a supplier. Consequently, an ongoing consideration of behavioral ethics can alter how a business is structured, how its employees interact, and its relations with third parties.

Chapter 2 Section 2 - Review Questions

The review questions accompanying this course are designed to assist you in achieving the course learning objectives. The review section is not graded; do not submit it in place of your qualified assessment. While completing the review questions, it may be helpful to study any unfamiliar terms in the glossary in addition to course content. After completing the review questions, proceed to the review question answers and rationales.

5. The elements of the fraud triangle include the following, **EXCEPT** for:

   a. Rationalization
   b. Perceived pressure
   c. Trust
   d. Opportunity

6. The following methods can be used to prevent the other side in a negotiation from telling lies, **EXCEPT** for:

   a. Open up about certain types of information early in the negotiations
   b. Ask tightly framed questions
   c. Set a trap where you already know the answer to a question
   d. Appear well-prepared throughout the negotiations

Review Question Answers and Rationales

Review question answer choices are accompanied by unique, logical reasoning (rationales) as to why an answer is correct or incorrect. Evaluative feedback to incorrect responses and reinforcement feedback to correct responses are both provided.

Chapter 1

1. The _______ approach to ethics focuses on what individuals should do to be morally responsible.

   a. Virtue ethics. Incorrect. Virtue ethics holds that the correct ethical behavior is based on the character of the individual.
   b. Intuitive. Incorrect. The intuitive approach holds that individuals react intuitively when confronted with a moral dilemma.
   c. Descriptive. Incorrect. The descriptive approach uses case studies and role playing to allow people to choose their own moral path.
   d. Normative. Correct. The normative approach assumes that people are rational and understand their actions, so the application of specific rules to them should be effective.

2. The following contextual condition tends to be imposed by management:

   a. Peer impacts. Incorrect. An employee tends to follow along with and defend the actions of his or her peer group. These people tend to be at the same level within the organization.
   b. Social bonding effects. Incorrect. The feeling of connection that an employee has with a business tends to decline as the number of employees increases. This is more a function of company success than management imposition.
   c. Pressure. Correct. Managers can impose pressure to attain performance targets. This pressure can have a profoundly negative impact on the environment, since it colors many of the actions taken by employees.
   d. Wealth effects. Incorrect. The amount of wealth on display can cause employees to feel that they are not being given their fair share of company earnings. This is an incidental management effect that is caused by spending decisions.

Chapter 2 Section 1

3. A reasonable ethical infrastructure should have the following elements, **EXCEPT** for:

   a. Set stretch goals. Correct. When management sets stretch goals, it may be imposing so much pressure on employees that they are forced to engage in unethical activities in order to meet their goals.
   b. Have role models. Incorrect. Role models are needed in order to show employees the expected level of ethical behavior.

c. Present clear expectations. Incorrect. A code of conduct is needed, so that employees can see exactly what the organization expects of them.
d. Impose penalties. Incorrect. A system of penalties that is actively enforced is needed, so that employees will understand why they must follow the organization's ethical standards.

4. The following is a step a person might take who is convincing himself that he is not actually violating an ethical standard:

a. Stretch goals are imposed on lower-level employees. Correct. When lower-level employees must deal with difficult stretch goals, they are more likely to engage in unethical activities, which are then kept away from the responsible manager.
b. Outsourced functions are brought back in-house. Incorrect. A manager trying to avoid layoffs can outsource a function and let the supplier handle the layoffs.
c. Make a decision based on the information currently at hand. Incorrect. Someone trying to avoid an ethical violation will delay a decision by waiting for more information.
d. Accept responsibility for a decision. Incorrect. The person will try to shift responsibility for making a decision to another person.

Chapter 2 Section 2

5. The elements of the fraud triangle include the following, **EXCEPT** for:

a. Rationalization. Incorrect. A perpetrator rationalizes the situation as being acceptable. If this cannot be done, then the person is highly unlikely to commit fraud.
b. Perceived pressure. Incorrect. The presence of significant liabilities, habits, or social pressures are more likely to drive a person to commit fraud.
c. Trust. Correct. When management and other employees trust a person, it is easier to commit fraud, but this is not an essential ingredient of the fraud triangle.
d. Opportunity. Incorrect. There must be an opportunity to commit fraud, such as a control weakness that allows a person to steal assets.

6. The following methods can be used to prevent the other side in a negotiation from telling lies, **EXCEPT** for:

a. Open up about certain types of information early in the negotiations. Incorrect. When you give the other party certain types of information, the other party is more inclined to feel compelled to be more transparent.
b. Ask tightly framed questions. Incorrect. When a question is tightly-framed, the other party cannot give a partial or misleading answer, and so has no wiggle room within which to lie.
c. Set a trap where you already know the answer to a question. Correct. When you set a trap, the intent is not to prevent the other party from lying, but rather to catch the person lying.

d. Appear well-prepared throughout the negotiations. Incorrect. When you are well-prepared, the other party is less inclined to lie, since he will feel that he is more likely to be caught if he does so.

Glossary

This is a glossary of key terms with definitions. Please review any terms with which you are not familiar.

Behavioral ethics: The study of how people react to ethical dilemmas.

Crowding-out effect: A condition that occurs when a person's moral obligation is crowded out by other factors.

Descriptive approach: The use of case studies and role playing to resolve ethical dilemmas.

Detection theory: The concept that the probability of a transgression decreases as the probability of detection goes up.

Ethics: The study of how we ought to behave with others.

Euphemism: The substitution of a vague term for one that is considered to be harsh or blunt.

Fraud: A false representation of the facts, resulting in the object of the fraud receiving an injury by acting upon the misrepresented facts.

Fraud triangle: The three conditions that make fraud more likely, which are perceived pressure, opportunity, and rationalization.

Goal sickness: A condition that occurs when people focus so hard on a goal that they do not see the associated side effects of their actions.

Intuitive approach: The assumption that people automatically react to a situation, rather than deliberately thinking through the consequences.

Morals: Principles related to right or wrong conduct.

Normative approach: A focus on what individuals should do in order to be morally responsible people.

Virtue ethics: The belief that correct behavior is based on the character of the individual.

Waterbed effect: The concept that imposing too many rules will trigger an increase in ethical lapses.

Whistleblowing: The disclosure of wrongdoing within an organization to an outside party.

Index

Qualified Assessment

Behavioral Ethics
Course # 4160636, Version 1910
Publication/Revision Date:
October 2019

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1. A category of ethical position that is unique to the individual is:

   a. Variable values
   b. Virtues
   c. Moral mandates
   d. Sacred values

2. The following is a core virtue, as espoused by those who claim that correct ethical behavior is based on the character of the individual:

   a. Accuracy
   b. Temperance
   c. Knowledge
   d. Giving

3. The following is a reasonable example of an ethical weakness in a business environment:

   a. Not paying employees at equal pay levels
   b. Not making a donation to the corporate United Way campaign
   c. Not helping an injured person in the street
   d. Arriving early to claim the best spot in the company's parking lot

4. In what type of organizational structure are employees pressured to blindly accept the direction of management?

   a. Matrix
   b. Project
   c. Flat
   d. Hierarchical

5. According to the _______ theory, a business should create conditions in which there is a high probability of an incorrect action being caught.

   a. Last survivor
   b. Moral mandates
   c. Detection
   d. Justice

6. The following is a component of a fair decision making process:

   a. The decision making process changes over time
   b. Employees can give input before a decision is made
   c. For privacy reasons, the process associated with a decision is not revealed
   d. Decisions are communicated in public

7. Employees are more likely to follow a leader who:

   a. Already conforms to their expectations
   b. Sets himself up as a rebel
   c. Was hired from the outside
   d. Comes from the human resources department

8. Which of the following phrases is considered a euphemism?

   a. Billing falsification
   b. Fake inventory counts
   c. Improper depreciation calculations
   d. Earnings management

9. A company overwhelms the warehouse staff with dozens of rules for documenting the use of inventory. Inventory theft subsequently increases. This relationship is called:

   a. Crowding-out effect
   b. Goal sickness
   c. Waterbed effect
   d. Group effect

10. The following is an example of a possible rationalization for committing fraud:

    a. This is only borrowing for a short time, and I will pay it back
    b. The company has a general environment of permissiveness
    c. Employees are not accountable for their work
    d. Management rarely communicates with employees regarding acceptable behavior

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Behavioral Ethics
Course # 4160636, Version 1910

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