Ethical Leadership

A Primer on Ethical Responsibility in Management

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MEMORANDUM TO THE READER

These are challenging times in business ethics. I could not allow current events and controversies to pass without calling special attention to issues of personal ethics and ethical leadership that are so important today.

A unique author team developed this ethics primer as a prologue to the special "Ethical Leadership" update edition of *Management 7/E.* John W. Dienhart is the Boeing Frank Shrontz Chair for Business Ethics at Seattle University; Director of the Northwest Ethics Network, and past President of Society of Business Ethics. Terry Thomas is an attorney and lecturer, and was formerly Director of Ethics Operations at The Boeing Company.

I urge you to read and participate in the activities of this ethical primer as a prelude to the rest of the book. Read it as an essay, one that should provoke your critical thinking. As you read, ask and answer for yourself important questions such as these:

- What is ethics and what is ethical behavior?
- How can one understand and develop personal ethics?
- What can we learn from recent cases of failures in business ethics?
- How can you best prepare to master personal ethical challenges in your career?

The world at large needs ethical leaders to guide our governments and social institutions. The businesses and organizations of your community and mine need them also. Please join with me in grounding your study of management with commitment to the ethical leadership of organizations and to socially responsible business and organizational practices.

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The recent news has been full of sensational cases of corruption and ethical failures in the world of business. If you haven't been following the reports, and if you don't pay attention to the others that are sure to come, you will miss valuable information. These cases introduce us squarely to an issue that is center stage to your future career and professional well-being—"ethics" and its role in guiding the leadership of society's organizations.

This primer, "Ethical Leadership," will help frame your introductory study of management in an ethical context. It should be helpful, even indispensable, in building your confidence in dealing with ethical dilemmas and challenges in the workplace. It should also help you to further develop your personal moral framework as a guide for ethical decision making and ethical leadership in even the most complicated management situations.

Let's begin with a look at four scenarios, all drawn from real life. Consider each and answer for yourself the accompanying thought questions. We'll refer to these cases throughout the coming discussion.

Case 1 A midlevel manager at Fran-Tech, a Seattle software company, receives a CD-ROM containing the source code for a competitor's software product. The competitor is the market leader in the software niche in which both companies compete and is crushing Fran-Tech in the marketplace. An anonymous note accompanying the package states that the package was sent by a disgruntled employee of the competitor, and urges the recipient to use the data "as you see fit." The manager is considered to be a "star" performer by her boss and her peers. Once the manager realizes the contents of the CD-ROM, she picks up the telephone and calls her counterpart at the competitor. "I think I have something that belongs to you," she says. She returns the CD-ROM to the competitor.

> *Thought Questions*: (1) Why did she do this? (2) Why didn't she, at the very least, first make a copy before returning the CD-ROM? (3) Shouldn't she have called her supervisor or the legal department first before acting?

Case 2 Johnson & Johnson, a major global drug manufacturer, learns that seven users of Tylenol capsules, a popular over-the-counter pain reliever, have died in the Chicago area. Further investigation reveals that the poisonings were not accidental; the capsules had been tampered with, laced with deadly cyanide. The company is certain that the tampering occurred after the product was shipped from its plants, i.e., it was not the work of a disgruntled Johnson & Johnson employee. Top managers at the company, led by the CEO, take the following actions: Johnson & Johnson immediately withdraws all Tylenol from the market nation-wide, stops all Tylenol advertising, issues warnings to the public not to use any of its Tylenol products—not simply the capsules—and recalls all Tylenol products from the shelves, a total of 31 million bottles valued at over $100 million.

> *Thought Questions:* (1) was the company's reaction too drastic and too swift? Should the decision makers have waited until more facts were available? (2) Should the recall have been limited to the Chicago area? (3) Since the poisonings occurred after the product had left Johnson & Johnson's control and were clearly the work of some criminal, should J&J have denied responsibility for the acts?

Case 3 Merck, a large multinational pharmaceutical firm, discovers that a drug the company has marketed to treat horses against parasitic worms can also be developed into a drug for humans that prevents river blindness, a horribly disfiguring disease that causes total blindness in its victims. The disease afflicts millions of poor people in sub–Saharan Africa. The cost to develop the drug for use in humans, including the necessary clinical trials, will run into the hundreds of millions of dollars. Additional millions will be necessary to deliver the drug to the victims in Africa, as well as to educate them as to its effectiveness and proper use. Because the victims live in abject poverty, they cannot pay for the drug. Moreover, although Merck will receive some help from international relief agencies and governments, it will bear the majority of the costs of this project itself. Aside from acting as a cure for river Blindness, there is no other use for the drug. More than 20 years after beginning the project, Merck continues to distribute the drug free of charge, and thus to lose money.

> *Thought Questions:* (1) Why did Merck develop a drug whose only customers could not afford to buy it? (2) Is this type of public service better left to governments than to private companies? (3) Does Merck have the right to "waste" shareholders' money on products and activities that have no hope of ever turning a profit?

Case 4 Costco Wholesale Corporation, is an international members-only discount retail store. While investigating a move into the United Kingdom, its bankers are recommending a way of structuring a borrowing transaction so that both principal and interest on the loan are tax deductible, as opposed to interest only, as is generally the case. The transaction would provide both significant tax savings to and a lower effective rate of interest to Costco. The company's top management decides that although the transaction would follow the letter of the law, it would not fall within the "spirit" of the law. As Richard Galanti, CFO, said, "It did not pass the smell test." The company foregoes the tax benefits.

> *Thought Questions:* (1) Why should a company decline to do something that is legal, and that will deliver more profits to its shareholders? (2) What is the "spirit" of the law, and why should a company consider it?

ETHICS

In Chapter 6, "Ethical Behavior and Social Responsibility," **ethics** is formally defined as a code of moral principles that sets standards of what is "good" and "right" as opposed to "bad" or "wrong" in the conduct of a person or group. When we read the articles and hear the news reports about the corporations and people behind today's scandals—those of Andersen, Enron, WorldCom, and others—there is much to be concerned about. They inform us about trusted senior executives engaged in unethical behavior; they describe organizations that tolerated decisions and actions that enrich the few while damaging so very many. Those harmed by the unethical practices range from company employees who lost retirement savings, to stockholders whose investments lost value, to customers and society at large who paid the price of business performance gone sadly off course. Society deserves much better than this.

Ethics is the code of moral principles that sets standards of what is "good" and "right" as opposed to "bad" or "wrong" (see Chapter 6).

ETHICAL LEADERSHIP AND INTEGRITY

○ **Ethical leadership** is moral leadership that meets the test of being "good" rather than "bad," and "right" rather than "wrong" (see Chapter 13).

○ **Leadership integrity** is the leader's honesty, credibility, and consistency in putting ethical values into action.

We expect and demand today that organizations be run with **ethical leadership**, which is moral leadership that meets the ethical test of being "good" and not "bad," and of being "right" not "wrong." As discussed in Chapter 13, "Leading," ethical leadership is distinguished by the presence of true **leadership integrity**—the leader's honesty, credibility, and consistency in putting ethical values into action. The recent highly publicized scandals inform us of failures in ethical leadership and integrity. But let there be no mistake about it, there is a plethora of positive examples and ethical role models to be studied as well.

You will find in *Management 7/E,* many examples of people and organizations that are exemplars of ethical leadership and integrity unquestioned. You can find them also in this primer's opening scenarios. At FranTech, the manager voluntarily gave back competitor information that could have greatly helped her own struggling company. Johnson & Johnson probably destroyed millions of dollars worth of perfectly good Tylenol products as a result of a few isolated incidents. At Merck, the decision led to a financial loss and the firm has no hope of ever recouping its investment. Costco executives elected to forego a perfectly legal tax strategy that would have increased profits. The managers in all four cases took ethical actions. The underlying question is: "Why?"

THE ETHICS REFLEX

○ **Ethics reflex** is a nearly automatic tendency to do what is right, even when it might be contrary to the employer's interest.

These decision makers did what they thought was right, even though it was not—at least in the short run—in their best financial interests. We call this response the **ethics reflex**—ethical action taken without extensive delay or analysis. At times nearly automatic (see manager's notepad 1), it is a characteristic of ethical leadership. Individuals and organizations that exhibit the ethical reflex very often do not engage in cost–benefit calculations and/or engage in lengthy consultations with lawyers about ways to avoid liability or "manage" the situation. They tend to do what feels right; they do it reflexively; and, they let the consequences fall where they may.

At Costco the ethics reflex is evidenced by Richard Galanti's comment that the rejected alternative, with all of its potential advantages, just "did not pass the smell test." In the Tylenol case, we see it as Johnson & Johnson destroyed millions of dollars worth of perfectly good product. Although there could also have been hundreds or even thousands of cyanide-laced pills among the destroyed packages, it is also possible that they were only in the seven bottles already discovered. While these scenarios were surely considered, the decision makers acted decisively and ethically to address the immediate problem without wasting time. Their ethics reflex was to take what they considered to be the right steps—withdraw all Tylenol from the market.

CORPORATE CULTURE AND THE ETHICS REFLEX

Why do some people, when faced with choices between alternatives—some of which are legal, profitable, but ethically suspect—consistently choose the ethical course of action? The answer, we believe, lies with individual ethical integrity and corporate culture. The ethics reflex is common

MANAGER'S NOTEPAD 1

Key elements of the ethics reflex

- Occurs nearly automatically when ethical challenges arise
- Often requires personal courage
- Depends on *actions,* not mere words
- Can be a learned behavior
- Supported by organizational cultures that value integrity
- May cause short-term financial costs or other disadvantages
- Best way to create long-term, sustainable success

to individuals acting within a consistent **corporate culture** that values integrity. In Chapter 2, "Environment and Diversity," this culture is defined as the system of shared values that guides the behavior of organizational members.

Corporate culture is the system of shared values that guides the behavior of organizational members (see Chapter 2).

Organizational cultures that support and create the ethics reflex are incubated by the statements and, more importantly, by the actions of their leaders. When corporate leaders make it clear that the needs of customers come before profits and then act consistently with that promise, for example, they will attract employees with the same values. In this way a firm's ethical culture builds and continually reinforces itself over time. When surrounded by peers who expect and follow high ethical standards, even persons of somewhat lower personal integrity will often act in accordance with the higher standard. When executive leadership consistently demands ethical behavior and develops an organizational culture that supports the ethics reflex, it becomes a learned behavior on the part of employees. Over time this culture becomes so ingrained that when a situation arises, such as the Fran-Tech dilemma or the Merck river blindness project decision, the ethics reflex guides people toward the type of behavior the company values.

ON THE WRONG SIDE OF THE ETHICS REFLEX

The ethics reflex results when people have individual integrity and work in organizational cultures that support integrity. Unfortunately, the recent reports about business corruption, accounting scandals, and the like make it abundantly clear that some companies are not like this. They possess what might be termed a "negative" ethics. They develop cultures where the decision-making reflex is solely to promote short-term corporate profit, as well as personal gain and power for top executives. Such organizations have little or no regard for the moral correctness of behavior. Actions and decisions are viewed solely in terms of cost and benefit analysis of what is best at the time for the company and/or its privileged managers.

We would see quite different behaviors in the opening examples if the governing cultures in each case tolerated unethical behavior. In a negative ethical culture the manager at Fran-Tech would almost certainly choose to copy the source code that was offered to her. Why not use it and try to overcome her firm's competitive disadvantage? In the Tylenol case, Johnson & Johnson executives may have turned first to lawyers and financial analysts to quantify the risks of allowing their product to remain in the marketplace. At the extreme, they might have made their decision by comparing the costs of potential future deaths with the benefits of saving from destruction millions of dollars of product. In the Merck example, a culture that placed less value on customers would likely have led decision makers to cancel the river blindness project. After all, it would be a pointless waste of corporate resources. Finally, Costco executives would almost certainly have seized upon the tax loophole when entering the U.K. markets. Why forgo the obvious, and legal, advantages it offered?

In these negative examples, the decisions and behaviors exhibited by employees are the product of a prevailing organizational culture that does not place high value on ethical behavior. Importantly, such negative outcomes may occur even in settings where corporate documents and executive speeches carry ethical themes. Unless the leadership behavior matches the leadership and corporate messages, they will have little positive impact.

People in organizations are influenced by what company leaders both *say* and *do* in ethical situations. While nearly all companies have platitudes and slogans extolling the virtues of acting to high standards of integrity, too many executives fail to follow through by setting positive examples and consistently taking ethical actions. People in all organizations are keen observers of leadership behavior; they will quickly note any disparities between what leaders say and do. Once employees discover that the ethical culture is different from that stated in official documents or that executive leaders operate by a different set of rules, they will likely respond accordingly. Some will adjust their behavior, lowering personal standards to fit the actual culture. Others will seek alternative employment with an organization whose ethics and values are more compatible with their own.

DISCOVERING (AND DEVELOPING) PERSONAL ETHICS

The roots of the ethics reflex are found within the character of the individual. A person of integrity has a coherent set of ethical standards and acts on them even when it is difficult to do so. While we may be urged to develop integrity by our parents, teachers, church leaders, and government authorities, it is still a matter of personal choice and development. Simply put, you and we will only have integrity if we choose to have it and work hard to maintain it.

What choices, exactly, does a person of integrity make? To help answer this question, let's look at a series of actions that the majority would think lacks integrity.

Scene 1. A person is competing with a good friend for an assignment overseas. The person lies about the friend to secure an advantage.

Scene 2. A person pads their expense reports over a period of many years, costing the company tens of thousands of dollars.

Scene 3. A person refuses to grant a promotion to the most qualified candidate because he is Hispanic.

Scene 4. A person who does well in college and in preparatory courses is invited to a party the night before his CPA exam. He wants to leave, but ends up staying late and drinking too much. He goes to the exam blurry-eyed and confused.

In contrast to the behavior exhibited in scenes 1 and 2, people of integrity care about their personal relationships and the well-being of the groups of which they are members. In contrast to what happens in scene 3, a person of integrity respects human dignity (fairness, justice, and rights). And in contrast to scene 4, people of integrity can control themselves and follow through on their plans. Those who successfully master the challenges of personal integrity—to have it and consistently maintain it—possess at least two important understandings.

1. *Persons of high integrity have clear beliefs about what is ethical and what is not.* Having clear beliefs does not mean holding fixed and unchangeable beliefs or ignoring the views of others. We are always learning new, unintended consequences of our beliefs, and a mature decision maker takes this information into account. Thus, our ethics reflexes change over time as we see the results of our actions.
2. *Persons of high integrity have the commitment and creativity to act on these beliefs in efficient ways.* It is difficult to follow through on our ethics reflexes if others push back. Being a person of integrity does not always mean directly confronting others with whom we disagree. While some confrontations are unavoidable, many situations can be handled with integrity and finesse.

ETHICAL DEVELOPMENT IN FOUR DIMENSIONS

Ethics is essentially the study of how to live a good life. If the ethics reflex relies on a person having clear ethical beliefs about what is right and wrong in life, how can ethics be better understood at the personal or individual level? How can one best approach the challenges of personal ethical development? It helps to view ethical development in four dimensions: (1) self-development, (2) personal relationship development, (3) group development, and (4) human dignity development.

Ethics and Self-Development The self-development dimension of personal ethics focuses on the goals we have and how we pursue and attain these goals. Individually, for example, we can define our self-development in terms of financial, career, spiritual, family, and many other goals. If we look back on the Fran-Tech case, the manager involved saw her self-development in terms of honesty, integrity, and respect for the law. The software she received was stolen property. Because an honest citizen returns stolen property, the case for her was closed and the decision she made was not debatable. Importantly, by returning the code, she not only acted from her good character she also strengthened it. Our individual characters are built and reinforced one act at a time. The more we act in a particular way, ideally an ethical way, the easier it becomes to do so the next time.

Your ethical development

What kind of person do you want to be?

How do you want others to think of you?

How do you *not* want others to think of you?

Ethics and Personal Relationships Development The second ethics dimension, personal relationships development, focuses on the relationships we have with other persons. In the management context this is especially important in respect to the relationships we have with the people we work with, and in the groups in which we participate as members and leaders. It is important for people in organizations to work together. Cooperation builds as people help each other with projects and tasks. A business and its members benefit when employees act on the "you help me and I help you" principle, while mutually supporting high ethical standards.

In the Fran-Tech case, for example, the manager who returned the software strengthened the already trusting relationships she had with her boss, peers, and employees. She further increased her integrity in the eyes of others, with fellow employees likely to feel even more comfortable going to her for advice about difficult problems. She also began a trusting relationship with the competitor that could bear fruit for her and her company, should future opportunities for joint ventures or other forms of legal cooperation arise. At Costco, the decision not to take a legal but ethically suspect tax reduction publicly confirmed a key ethical value. The common vision of Costco held by each of the senior managers was supported. This reinforcement of shared understandings and ethical commitments likely further enhanced the trust in their working relationships.

Your ethical development

How do you define good relationships at work?

If someone asks you to return a favor, are you obligated to help if you feel uncomfortable doing what the person asks?

Ethics and Group Development The third ethics dimension focuses on the development of the groups in which we participate. Like individuals, groups and organizations can define their well-being in terms of financial, market, religious, civic, or other standards. These standards of the group will influence how we make individual decisions.

In the Fran-Tech case, the manager sent a positive message to the competitor about Fran-Tech's culture and goals, as well as her own character. By showing that Fran-Tech is an honest company that plays by the rules, she defies the notion that "dirty business" is the group norm. She also sent a powerful message within Fran-Tech that honest behavior on the part of the executive team is part of the culture, even if it seems to have short-run costs. Culture and group norms were also at play in the decisions of Merck, Johnson & Johnson, and Costco. Each of these companies has a strong statement of values that is not just window-dressing. The values are integrated into decision making throughout the firms, from the top down. With clear messages about how to act, decisions that would otherwise be agonizing, costly, and delayed can be made easily, efficiently, and quickly.

Your ethical development

What kind of groups do you want to identify with?

When are you uncomfortable with the decisions of a group?

How do you define the good of a business organization?

Ethics and Fairness, Rights and Human Dignity The fourth ethics dimension focuses on the extent to which the practices in which we engage and the organizations in which we participate are fair and just and respect human rights. We can evaluate fairness in terms of outcomes, processes/procedures, or both. Outcome fairness works in situations where the outcomes are easy to evaluate. If you and your friend split the cost of a pizza, the fair outcome is easy to determine—you each get half to eat. In many business situations, however, the fair outcome is not easy to determine. Thus, we try to develop fair *processes* so that results are considered fair. This idea should have a familiar ring; it underlies the notion of *due process* that is embedded in the United States's constitutional form of government.

In the financial world of business, people invest their money in public companies by buying stock. They expect a fair return on their money, just as the pizza buyers expect a fair return on their purchase price. There are two ways a company rewards investors. One way is through an increase in stock price. A well-run company should draw more investors. As people compete for the stock, the stock price goes up, and previous owners are rewarded. The second way is through dividends. Companies take some of the profits and distribute them to shareholders. Besides

Your ethical development

How do you define fairness, rights, and human dignity in the context of business operations?

How important is it for you to work in a business that is fair and respects the rights of all?

giving owners a cash return, the announcement by a company that it will pay dividends can also increase the stock price, thus giving owners a double reward. The question is: What constitutes a fair reward for investors?

The answer to this question of fairness is not as easy to determine as is the case of two friends splitting a pizza, and there is more room for unfair rewards to be made. A company's financial statements and forecasts, for example, heavily influence stock price. If those reports are good, the stock price can increase quickly. Inaccurate financial reports that overstate the performance of the company completely disrupt the process. Those unaware of the inaccuracies will frequently drive up the price of the stock by buying in reliance on the false information, only to lose money when the lies are revealed. Those who know that the reports are false, however, will sell their stock while it is still high, reaping an unfair reward before the stock loses its value.

There are two processes designed to protect against such corrupt practices, and to ensure that the financial reports and forecasts made by businesses are accurate and that no one unfairly gains rewards. The first is **corporate governance**—oversight of management decisions and company actions by Boards of Directors that are supposed to represent the interests of stockholders. The second is **auditing**, an external assessment by independent and certified accounting firms that guarantees the accuracy of financial reports. In our imperfect world of business, as illustrated by the recent cases of Andersen, Enron and WorldCom, both of these processes can break down.

- **Corporate governance** is the oversight of management decisions and company actions by Boards of Directors that are supposed to represent the interests of stockholders.

- **Auditing** is an external assessment by independent and certified accounting firms that guarantees the accuracy of financial reports.

WHEN BUSINESS ETHICS FAILS

Businesses and other organizations operate in complex civic, political, and economic environments. They both influence these environments and are influenced by them in return. In this setting, ethical business decision making creates value for a business entity by promoting sustainable networks of individuals, personal relationships, and groups in a context of human dignity. This perspective on business ethics starts with the responsibility of business decision makers to look after the well-being of their organization. That is what they have promised to do, and the many business stakeholders depend on their performing that role well.

Corporate social responsibility, as discussed in Chapter 6, "Ethical Behavior and Social Responsibility," refers to the obligations a business has to many stakeholders. The narrowest view considers corporate social responsibility an obligation to obey the law. However, the developing consensus supports a more expansive definition that includes commitments to work with employees, their families, the local community, and society at large to improve the quality of life. Businesses, like societies, are increasingly evaluated by the extent to which they are fair, just, and respect the rights of all.

- **Corporate social responsibility** is the obligation of a business to external stakeholders (see Chapter 6).

The actions and decisions in the four cases that began this primer reflected the ethics of corporate social responsibility. And, although the managers did not focus on the short-term financial well-being of their company as their first or only priority, their companies benefitted or at least were not harmed by their ethical actions. Fran-Tech avoided the risk of having to battle civil or even criminal charges for using stolen information. Johnson & Johnson remained one of the most trusted names in the pharmaceuticals industry. Merck was able to initiate important relationships with developing nations. Costco avoided damage to its reputation as it entered the United Kingdom.

When business ethics do not support corporate social responsibility, by contrast, the costs of failure can be very high for all concerned.

THE CASE OF ARTHUR ANDERSEN

Arthur Andersen, LLP was until recently one of the largest certified public accounting firms in the world. Its client base included a diverse mix of companies and organizations ranging from huge global corporations to the City of New York. Andersen, like many other accounting firms, provided two types of services to its clients: auditing and consulting.

Andersen's auditing business involved the traditional auditing of financial statements. When it provides this service, an accounting firm examines the financial books and records of the client and compares its business dealings to generally accepted accounting practices. If it finds the financial activities of the client in order, the accounting firm issues a letter included in the client's annual report, certifying that the client meets the accounting standards of the industry. This certification is important; it is legally required for all companies that are publicly traded in the United States. Investors, from individuals to large institutions, rely on the accounting firm's certification as part of their decision to buy the client's stock.

Over the last several years major accounting firms, like Andersen, added business management consulting to their business portfolios. Management consultants provide advice to clients on a wide variety of business matters, ranging from how best to structure business transactions to how to manage suppliers or employees. Because public accounting firms become so familiar with their clients' businesses during the auditing process, it seems logical to use that knowledge for the additional purpose of management consulting for the same clients. Management consulting is very lucrative; often, the fees generated from this activity dwarf those generated from the auditing activity.

○ **Conflict of interest** is where one goal or business task is compromised in service to another.

This dual role of auditor and management consultant has led to **conflicts of interest,** where one goal or business task is compromised in service to another. For example, an auditor is supposed to maintain a skeptical independence, acting as a sort of watchdog, and questioning the client closely about its financial practices to ensure that they are proper. When, however, the auditing firm is also trying to sell its business consulting services to that same client, its incentive to maintain its independence may be compromised, out of fear of angering the client, who may send its consulting business to a competitor. Further, when an accounting firm provides both management consulting advice and auditing services to the same client, it may find itself in the awkward position of passing judgment as an *auditor* of the very management practices it recommended as a *management consultant.* This places the accounting firm into a direct conflict of interest situation, because its duty to perform a thorough audit may conflict with its desire to provide innovative business consulting strategies, the propriety of which might be questioned by an aggressive auditor.

One of Andersen's most important clients was Enron, a huge Houston-based energy company. Andersen provided both auditing and manage-

TAKE IT TO THE CASE!

***Enron* The Consequences of Ethical Failure**

When the news hit, it was almost unbelievable. How could a major multinational company fail so miserably and so dramatically? How could the employees of a major American business lose their hard-earned retirement savings almost overnight? How could highly paid senior business executives go so sadly off course, apparently placing individual gain and self-interests above all else? Visit Internet sites, read as much as you can, and follow the daily news reports as the Enron debacle further unfolds and the firm and some senior executives face the justice system. Included with this update edition of *Management 7/E* is the Enron Case on CD-Rom. Take advantage of it as an opportunity to further your understanding of the ethical context of business and advance your quest for the strongest possible foundations of personal ethical development.

ment consulting services to Enron, thus performing the dual role described above. In November 2001, after years of extremely high profits, Enron disclosed that certain accounting problems, which occurred while Andersen was its auditor, would force it to restate, or change, prior financial reports. These changes caused Enron to report a huge $618 million net loss for the third quarter of 2001. The effect on Enron's stock was devastating—by late fall it had plunged to a mere fraction of what it had been less than a year before. Investors—many of them Enron employees—lost billions of dollars as a result.

Blame for Enron's bad news has been laid in part at the feet of Andersen. As the entity responsible for auditing Enron's financial statements, many commentators assert that it should have been aware of the large transactions that were now being called into question. Many further asserted that Andersen had been caught up in the conflict of interest problem that arises from the dual role of providing both auditing and business management consulting services. Making matters worse was the revelation that, at the same time the problems at Enron came to the public's attention, a senior Andersen employee ordered the destruction of documents relating to the audit work. This action, which was a deliberate effort to withhold evidence that government regulators would be seeking in its investigation of Enron's problems, constituted the serious crime of obstruction of justice. The employee who directed the document destruction soon after plead guilty to the crime, and Andersen itself was indicted, tried, and convicted of the same crime in spring 2002.

Andersen's ethical and legal failures in the Enron case can be summarized as follows:

- Andersen failed in its audit duty to question certain Enron transactions.
- Andersen had an inherent conflict of interest because it performed the dual roles of auditor and management consultant to Enron.
- Andersen, acting through its employees, committed the crime of obstruction of justice in an attempt to cover up its unethical acts.

BUSINESS COSTS OF ETHICAL FAILURE

Andersen's ethics failures in the Enron matter were extensive. Figure 1 divides the business costs of such ethical failures (see also manager's notepad 2) into three categories. The first cost, represented by the inner-

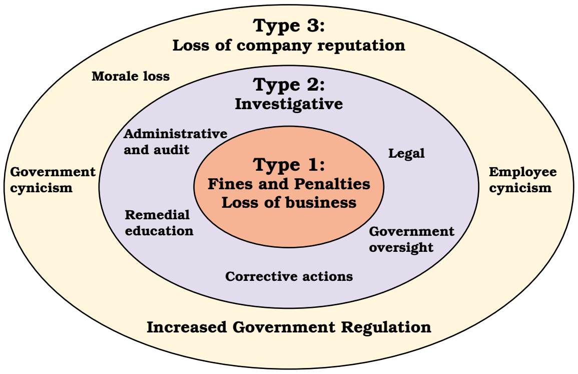

Figure 1 Business costs of ethics failure.

most circle on the chart and labeled *Type 1 costs,* is the easiest to show. At sentencing for its conviction of the crime of obstruction of justice, Andersen will in all likelihood receive a huge fine. In addition, as soon as the company was indicted, even before it was tried and convicted, it began losing business. Dozens of the Andersen's longstanding clients deserted it, choosing to fire Andersen and send their work to its competitors. This loss of present and future business was devastating to Andersen.

Andersen also suffered a further category of costs, shown as *Type 2 costs* in the figure. Type 2 costs include such things as attorney's fees, investigative costs, and the other costs shown. To defend itself against lawsuits filed by clients, investors, and the government, Andersen had to retain the services of expensive lawyers, auditors, and other professionals who are called in when a firm gets into serious trouble. These costs can run into the multiple millions of dollars. Further, on August 16, 2002 Andersen lost its Texas state accounting license, and was thus forbidden from doing further accounting work in that state.

The outer ring of the diagram shows *Type 3 costs,* which include such things as reputation loss, morale loss, employee and government cynicism, and increased government regulation. These costs are abstract and difficult to quantify, but they can be devastating to a firm. In the Andersen case, the Enron matter left the firm's reputation in shreds; the firm's problems became the subject of front-page news, late-night television jokes, and editorial cartoons. Morale among employees, the vast majority of whom had done nothing wrong and had had no involvement in or responsibility for the Enron debacle, plunged. Many, fearing for their jobs, left the firm, causing a severe talent drain. Finally, in direct response to the Arthur Anderson/Enron disaster, the U.S. government got involved. Congress began considering legislation that would add significant new accounting oversight responsibilities and stiff new penalties for financial reporting crimes such as may have occurred in this case.

Each Type 3 cost in the Andersen case proved to be enormously expensive. But the damage from this ethics failure is more widespread than just the devastating costs to Andersen. Sadly, the costs of ethics failures are almost never limited to the wrongdoers themselves. Other firms in the same line of business also feel the sting of additional regulation and the loss of public trust. As it becomes more costly to do business, this is passed on to the consumer, who ends up paying more for products and services.

MANAGERS NOTEPAD 1

Understanding the Business Costs of Ethical Failure

Type 1 Costs: *Fines, Penalties, and Lost Business*

- Easily quantified
- Can be extremely high

Type 2 Costs: *Investigative, Legal, and Administrative costs*

- Harder to quantify
- Often overlooked in assessing costs of ethics failures
- Can be extremely large; can even exceed Type 1 costs

Type 3 Costs: *Intangible Costs That Damage Business*

- Very difficult to quantify: What is the value of a reputation?
- Usually overlooked in assessing costs of ethics failures
- Can be devastating to a company; overall, can cost more than Types 1 and 2 combined

GOVERNMENT RESPONSES TO ETHICAL FAILURES

When a series of spectacular failures such as Enron, Andersen, and WorldCom occurs, regulatory authorities, spurred by public outcry, often move to act. Their goal is to pass laws that will force companies to act ethically. Typically, this is done in two ways: (1) new, stricter regulation and (2) more severe penalties for failures.

BUSINESS ETHICS AND THE LEGAL ENVIRONMENT

The U.S. Government has a long history of passing laws in response to ethical lapses by companies. In 1863, following fraudulent "war profiteering" by companies engaged in rebuilding the nation after the Civil War, Congress passed the Federal False Claims Act. This law, still in effect today, provides stiff penalties for any person or company that makes a false claim, generally for payment of money, against the government. Companies convicted under the law face not only criminal sanctions, but also civil monetary penalties of three times the dollar loss suffered by the government, plus fines of $10,000 for each false claim submitted. For a large company, such a penalty may be a mere monetary nuisance, though the negative publicity and other costs of such an ethics failure, as described in the previous section, are likely to be far greater. For a small company, however, a large judgment against it under the False Claims Act can be a death knell, particularly if its proprietors also face personal criminal charges.

The False Claims Act has another powerful provision regarding **whistleblowers**—employees who discover and report ethical misconduct. In respect to this act, whistleblowers are able to bring private civil actions, called *qui tam,* or whistleblower suits, against their employers. If the suit is successful, the whistleblower can recover a portion of the amount recov-

Whistleblowers are employees who discover and report ethical misconduct (see Chapter 6).

ered as a reward. Whistleblowers have thus obtained rewards in the millions of dollars for turning on their employers.

In 1977, following a scandal where American aerospace executives paid huge bribes to Japanese government officials in connection with a sale of aircraft, Congress passed the Foreign Corrupt Practices Act (FCPA). The FCPA makes it a criminal offense for American businesses to pay bribes to foreign government officials to secure business. Penalties for violating the FCPA are severe; they can amount to millions of dollars in fines, plus jail time for the individuals involved. Since passage of the FCPA, several companies have been prosecuted, and several executives have been sentenced to jail.

In 1991, following a series of scandals involving the defense and other industries, Congress passed a comprehensive set of guidelines to be used when sentencing corporations convicted of committing crimes. These guidelines greatly increased the penalties for corporate wrongdoing. In addition to the "stick" approach of enhanced penalties, however, the guidelines introduced something new, a "carrot." Companies who can demonstrate that they have in place an effective program to detect and prevent violations of law can receive a significant reduction in their fines. The thinking behind this provision is to encourage companies to create programs of codes of ethics, ethics training, employee reporting systems such as hotlines, and other methods aimed at preventing wrongdoing. If a company can show that it has taken such good-faith steps, but that employees nevertheless committed a crime, it may have its fine reduced to as little as 5% of the base amount.

In 2002, in response to the accounting scandals at Enron, Andersen, WorldCom, and others, Congress passed the Sarbanes-Oxley Bill (H.R. 3763, § 201). This law creates a new national accounting oversight body, called the Public Company Accounting Oversight Board, which will operate under the auspices of the federal Securities and Exchange Commission. The Board has vast powers to oversee the accounting industry. The Act also forbids companies that do auditing work from also providing management consulting services, although the Act does provide for limited pre-approval of such dual activities in some cases. Thus, the dual role of auditor and management consultant played by accounting firms, such as Andersen, for many years has been made unlawful by government regulation. This change in the law will have a profound effect on accounting firms that have developed their management consulting businesses in tandem with their auditing practices. In addition, the Act imposes strict new reporting requirements on companies and their upper management. For example, the CEO and CFO now must personally certify the accuracy of financial data disclosed in financial reports. The Act also provides for far stricter penalties for financial frauds.

CAREER CONNECTION

Ethical Decision Making

It is the middle of a busy workday. A supplier with whom you do a lot of business calls you. He invites you to Las Vegas for a four-day weekend with all expenses paid. "I just want to say thank you for all the business you have given my firm," he says. Should you accept or decline? If you decline, how should you do it?

When you work for an organization that has a strong ethics program, like the Boeing Company, such ethical dilemmas are easily handled. You should already know what to do—you must decline. Even when unsure, a Boeing employee can consult ethical guidelines on the company's Web site, or even call anonymously for advice at an 800 number. Declining is easy. You thank the vendor for the offer, but cite Boeing's policy that forbids accepting such invitations.

QUESTION: Are you examining the ethics programs of potential employers? Do you understand the importance of finding a good fit between corporate culture and personal ethical standards?

BEYOND LAWS AND GOVERNMENT REGULATIONS

With all the laws on the books aimed at preventing corporate wrongdoing, one might be tempted to think of it as a thing of the past. Yet even as more and more regulation is put on the books, corporate wrongdoing continues. If nothing else, the fact that lawbreaking continues in the face of all these strict regulations proves that it is simply impossible to control through written law all aspects of human behavior. Many people will willingly violate any law on the hope or belief that they will not be caught. Others will violate laws that they consider unnecessary or insignificant, such as speed-limit laws. Still others will devise schemes that, while technically legal, are nevertheless morally or ethically wrong.

For these reasons, we contend that corporations must create their own ethical environments—cultures of integrity based upon shared values that are clearly set forth, embraced by all employees, and evenly applied. This will support and establish a climate for the positive ethics reflex described earlier in this primer.

Cultures of integrity in businesses can manifest themselves in both internal and external ways. Internally, companies may devise codes of conduct or codes of ethics that govern how the business will be run and how, for example, employees will be treated. Externally, businesses can choose to interact in certain ways with the world beyond the narrow interests of the company itself, in an effort to improve the lot of all of society.

Virtually all businesses have some sort of culture of integrity. Some value it highly, considering it a key competitive advantage; others largely ignore it. Most companies begin their efforts to develop an internal culture of integrity by adopting a written **code of ethics**—a formal written statement of ethical commitments and expectations. This can be either detailed and elaborate, or fairly simple. Costco, for example, has a simple yet highly effective mission statement that sets forth its code of ethics:

A **code of ethics** is a formal and written statement of ethical commitments and expectations (see Chapter 6).

> Costco's mission is to continually provide our members with quality goods and services at the lowest possible prices. In order to achieve our mission, we will conduct our business with the following Code of Ethics: A. Obey the Law B. Take Care of Our Customers C. Take Care of Our Employees D. Respect Our Suppliers E. Reward Our Shareholders

From this statement of values, Costco has developed a culture of integrity that forms the basis for far more complex decisions such as those faced in the examples that began this primer. Some businesses, unfortunately, *talk* about their integrity while their actions display that no such culture exists. A good example is Enron. This company had an elaborate code of ethics, but ignored it in several significant dealings that eventually caused the company to disintegrate.

ETHICAL LEADERSHIP: A PERSONAL CHALLENGE

In the final analysis, we must each ask ourselves an important question: Why be ethical? In the best of circumstances the ethical course of action often goes unrewarded. In the worst circumstances it can cost us opportunities for success, or threaten our livelihoods or even our very lives. There

Remember the Key Terms

- Auditing
- Business ethics
- Code of ethics
- Conflicts of interest
- Corporate culture
- Corporate governance
- Corporate social responsibility
- Ethics
- Ethical behavior
- Ethical leadership
- Leadership integrity
- Whistleblower

are examples all around us of unethical behavior going unpunished or, in some cases, even being rewarded. With wildly successful yet unethical public figures ranging from CEOs of Fortune 500 companies to government leaders, it may seem that ethics remains the quaint province of the hopelessly old-fashioned, the out-of-touch. But this is simply wrong.

We have communicated throughout this primer what we believe to be the core truth about ethics in business and in life: *Long-term, sustainable success can only be built upon a foundation of solid ethical behavior.* We should not endeavor to be ethical out of fear of being caught, but rather because of the freedom and success that it brings. Our experience is that the most ethical people are those who have the least fear. They are blessed with the confidence that comes with knowing that their actions are beyond reproach. And in contrast to the few notorious cases of ethics failures that are the stuff of the evening news, history has proven time and time again that those who do good eventually win.

We encourage you to examine all of the topics in *Management 7/E* from the standpoint of ethics. When viewed through the lens of what is truly the right thing to do, many business and management decisions become easier, not harder. It is perhaps that ease, that peace of mind, that is the most reliable indicator of a strong and consistent ethics reflex—the one that we sincerely hope you develop, maintain, and protect throughout your life and professional career.