Significant Ethics Issues Facing Business and the Accounting Profession

Introduction

Part III explores how directors, executives, and accountants should approach specific decisions and the ethical management of key aspects of a corporation's activities within the frameworks for ethical awareness, accountability, and governance developed in Parts I and II.

Chapter 5 provides philosophical and practical approaches to making ethical decisions. Frequently, an employee or professional cannot discern precisely what action to take from a code or cannot consult a colleague and must decide for him or herself what to do. The approaches discussed will facilitate the development of both a defensible decision and an improved, proposed action. Both outcomes will be of increasing value in the future.

Chapter 6 develops an understanding of several key ethics opportunities and risks facing corporations and a set of tools to deal effectively with them. Topics covered include:

- Ethics risk and opportunity management—a new concept;
- Ethics strategies and tactics for effective stakeholder relations;
- Workplace ethics;
- International operations;
- Corporate social responsibility/accountability and audit;
- Crisis management.

Approaches to Ethical Decision Making

Purpose of the Chapter

When a businessperson or professional accountant faces an ethical problem, the first recourse for guidance should be to corporate and professional codes of conduct. These often do not apply specifically to the problem faced and require interpretation to fit the circumstances. When this is required, the decision maker should be able to use the principles, approaches, and frameworks discussed in this chapter to make defensible ethical decisions.

INTRODUCTION

When the broad principles or specific rules embodied in codes of conduct do not specifically apply to the particular problem a professional accountant is facing, the decision maker can be guided by general ethical principles to arrive at a defensible ethical decision. What are these general ethical principles and how should they be applied? This chapter explores these ethical principles first by reviewing three fundamental philosophical approaches to ethical decision making, and then by developing a practical decision framework based upon how a proposed action would impact upon the stakeholders to the decision. The chapter concludes by proposing a comprehensive framework for making ethical decisions.

Recent Developments

The Enron, Arthur Andersen, and WorldCom scandals gave rise to public outrage, the collapse of capital markets, and ultimately the Sarbanes-Oxley Act of 2002, which brought about widespread governance reform. Subsequent corporate scandals involving Adephia, Tyco, HealthSouth, and others served to further heighten public awareness that corporate executives can make better decisions. Ensuing court cases as well as related fines, imprisonments, and settlements have underscored the need for those decisions to result in legal actions.

The court of public opinion has also been harsh to companies and individuals who have behaved unethically. Loss of reputation due to unethical and/or illegal acts has proven to be revenue and profit reducing, damaging to share prices, and career ending for many executives even before the acts are fully investigated and responsibility for them is fully proven.

These developments have been so important that corporate executives and directors now must give increased attention to corporate governance and the guidance it provides, in addition to their own role. Additionally, business schools that want worldwide accreditation by the Association to Advance Collegiate Schools of Business (AACSB)[1] are to incorporate ethics education into their policies, practices, and curricula. Specifically, according to the AACSB's Ethics Education Task Force,[2] business school curricula should deal with several ethical matters, including corporate social responsibility, governance, ethical corporate culture, and ethical decision making (AACSB, 2004).

In 2003, the International Federation of Accountants (IFAC) also pronounced upon the ethics education required for ethics education of professional accountants. Their International Education Standards for Accountants (IES 1-6, 2003) provides, in IES 4, the details of the professional values, ethics, and attitudes required for professional accountants to understand and discharge their duties under the IFAC Code of Ethics for Professional Accountants.[3]

The lesson is clear. It is no longer enough to make decisions and take actions that are legal—actions must also be ethically defensible.

Ethical Decision-Making Framework (EDM)

In response to the need for ethically defensible decisions, this chapter presents a comprehensive multifaceted framework for ethical decision making. This framework incorporates traditional requirements for profitability and legality, as well as requirements shown to be philosophically important and those recently demanded by stakeholders. It is designed to enhance ethical reasoning by providing:

- Insights into the identification and analysis of key issues to be considered and questions or challenges to be raised
- Approaches to combining and applying decision-relevant factors into practical action

A decision or action is considered ethical or "right" if it conforms to certain standards. Philosophers have been studying which standards are important for millennia, and business ethicists have recently been building on their work. Both groups have found that one standard alone is insufficient to ensure an ethical decision. Consequently, the EDM framework proposes that decisions or actions be compared against four standards for a comprehensive assessment of ethical behavior.

The EDM framework assesses the ethicality of a decision or action by examining the:

- Consequences or well-offness created in terms of net benefit or cost;
- Rights and duties affected;
- Fairness involved;
- Motivation or virtues expected.

The first three of these considerations—*consequentialism, deontology*, and *justice*—are examined by focusing on the impacts of a decision on shareholders and other

[1] Association to Advance Collegiate Schools of Business (AACSB) accredits business schools and programs worldwide. See www.aacsb.edu.

[2] The AACSB's Ethics Education Task Force is at http://www.aacsb.edu/resource_centers/EthicsEdu/eetf.asp.

[3] IES 1-6, including IES 4, is reproduced on the BPA website for further reference.

affected stakeholders, an approach known as *stakeholder impact analysis*. The fourth consideration—the *motivation* of the decision maker—is an approach known as *virtue ethics*. It provides insights likely to be helpful when assessing current and future governance problems as part of a normal risk management exercise. All four considerations must be examined thoroughly and appropriate ethical values must be applied in the decision and its implementation if a decision or action is to be defensible ethically.

Practical EDM—the overriding focus of this chapter—is based upon concepts developed by philosophers. Consequently, developing an understanding of the decision-making approaches philosophers pioneered is useful. Table 5.1 provides a cross-reference of EDM considerations and relevant philosophical theories.

http:// For reference purposes, a list of definitions is provided at www.thomsonedu.com/accounting/brooks.

Philosophical Approaches: Consequentialism, Deontology, and Virtue Ethics

Philosophers have long been focused on making the best decision from a societal as well as individual perspective, but the salience of their philosophies has not been well-appreciated or understood in business and the professions. This is about to change.

TABLE 5.1 EDM Considerations: Philosophical Underpinnings

EDM CONSIDERATIONS	PHILOSOPHICAL THEORIES
Well-offness or well-being	Consequentialism, utilitarianism, theology[4]
Respect for the rights of stakeholders	Deontology (rights and duties)[5]
Fairness among stakeholders	Kant's Categorical Imperative,[6] justice as impartiality[7]
Expectations for character traits, virtues	Virtue[8]
Specific EDM Issues	
Different behavior in different cultures (bribery)	Relativism,[9] subjectivism[10]
Conflicts of interest, and limits to self-interested behavior	Deontology, subjectivism, egoism[11]

[4] See John Stuart Mill (1861/1988).

[5] See, for example, http://en.wikipedia.org/wiki/Deontology, or http://www.molloy.edu/academic/philosophy/sophia/kant/deontology.htm.

[6] See Immanuel Kant (Stumpf, 1988).

[7] See Rawls (1971).

[8] See Cafaro (1998) at http://www.bu.edu/wcp/Papers/TEth/TEthCafa.htm.

[9] See, for example, http://plato.stanford.edu/entries/relativism/.

[10] See, for example, http://academics.vmi.edu/psy_dr/subjectivism.htm.

[11] See, for example, http://www.iep.utm.edu/e/egoism.htm or http://plato.stanford.edu/entries/egoism/.

Stimulated to improve ethics education and EDM by the Enron, Arthur Andersen, and WorldCom scandals, and the ensuing governance reform, the AACSB Ethics Education Task Force (2004) has called for business students to be familiar with three philosophical approaches to ethical decision making: *consequentialism, deontology,* and *virtue ethics.* Each of the three approaches contributes differently to a useful and defensible approach for ethical decision making in business or personal life. However, since some philosophical principles and theories conflict with others and appear to clash with acceptable business practice, particularly in some cultures around the world, it is best to use a multifaceted set of considerations drawn from all three approaches to determine the ethicality of actions, and guide choices to be made.

The basic question that interests philosophers is: What makes a decision or action or person more or less good or ethical? Each of the three philosophical approaches to ethical decision making—consequentialism, deontology and virtue ethics—focuses on a different conception of a right action. These will be reviewed in turn. Bear in mind, however, since philosophers have been studying what makes an act good or morally right for thousands of years, it is not possible to provide a complete understanding of philosophical concepts in a few pages. The following brief understanding of underlying philosophical approaches is intended to enable the use of the practical decision techniques developed later in this chapter. Readings are cited to facilitate further study of philosophical concepts.

Consequentialism, Utilitarianism, or Teleology

Consequentialists are intent on maximizing the utility produced by a decision. For them, the rightness of an act depends upon its consequences. This approach is essential to a good ethical decision and an understanding of it will be part of AACSB-accredited business school education in the future. According to the AACSB,

> The consequentialist approach requires students to analyze a decision in terms of the harms and benefits to multiple stakeholders and to arrive at a decision that produces the greatest good for the greatest number.[12]

Consequentialism holds that an act is morally right if and only if that act maximizes the net good.[13] In other words, an act and therefore a decision is ethical if its favorable consequences outweigh its negative consequences. Moreover, some believe that only the act that maximizes the net benefit of favorable minus negative consequences is morally right or ethical. Philosophers also debate:

- Which consequences should be counted;
- How they should be counted;
- Who deserves to be included in the set of affected stakeholders that should be considered.

For example, should the consequences to be considered be actual rather than foreseen, foreseeable, intended, or likely? Should the consequences to be considered

[12] AACSB, 2004, 12.

[13] Alternatively, an ethical choice could be the one that minimizes the net negative impact of choices where one *must* be made.

depend on the values involved, such as the impact on life, health, pleasure, pain, privacy rights, or property rights; and with what weighting? How should the overall assessment be developed?

- Based only on the best consequences instead of:
  - attributing value to only satisfactory outcomes,
  - on all of the outcomes or just parts thereof.
- Based on total net good rather than average per person.
- Based on the impacts on all persons or just a select set.
- Based on the assumption that all consequences are considered of equal impact or that some are more important.
- Should the impact of the act on the decision maker or agent involved be considered?

An excellent overview of these variations and useful references can be found in the work of Walter Sinnott-Armstrong (2003).

Classic *utilitarianism*—concerned with overall utility—embraces all of these variants, and therefore it is only of partial usefulness in making ethical decisions in a business, professional, or organizational context. *Consequentialism*, however, refers to a subset of these variants that may be defined to avoid problematic measurements or other issues, or in order to make the process more relevant to the act, decision, or context involved. Because utilitarianism and consequentialism focus on the results or "ends" of an action, they are sometimes referred to as *teleological*.[14]

In the development of the practical EDM approaches that follow, this chapter will adopt a consequentialist approach involving the impact analysis of decisions and actions upon a comprehensive set of stakeholders and their interests, based upon foreseeable likely impacts, which are value weighted in importance. The total net benefit of alternative decisions and actions is considered to identify the best and/or most defensible choices.

Deontology

Deontology[15] is different from consequentialism in that deontologists focus on the obligations or duties motivating a decision or actions rather than on the consequences of the action.

Deontological ethics takes the position that rightness depends upon the respect shown for duty, and the rights and fairness that those duties reflect. Consequently:

> A deontological approach raises issues related to duties, rights, and justice considerations and teaches students to use moral standards, principles, and rules as a guide to making the best ethical decision.[16]

Deontological reasoning is largely based upon the thinking of Immanuel Kant (1988). He argued that a rational person making a decision about what

[14] *Teleos* in Greek means "end," and the study of "ends" is known as teleology.

[15] *Deon* in Greek means obligation.

[16] AACSB, 2004, 12.

would be good to do, would consider what action would be good for all members of society to do. Such an act would improve the well-being of the decision maker and the well-being of society as well.

Kant began to search for an overriding principle that would guide all action—an imperative that everyone should follow without exception, which could therefore be considered universal or categorical. His search led to what is known as Kant's Categorical Imperative, which is a dominant principle or rule for deontologists. Kant's principle indicates that there is a duty or imperative to:

> Always act in such a way that you can also will that the maxim of your action should become a universal law.[17]

This means that "if you cannot will[18] that everyone follow the same decision rule, your rule is not a moral one" (Kay, 1997).

As a universal principle, everyone should follow it. Suppose a person is considering whether to lie or tell the truth. Kant would argue that lying would not be a good rule because others following the same rule would lie to you—an eventuality you would not want. Honesty would, however, qualify as a good rule. Similarly, impartiality would also qualify rather than favoritism. Moreover, the Golden Rule—do unto others as you would have them do unto you—would readily[19] qualify as a universal principle.

Using the same approach could yield a universal respect for human rights and for fair treatment for all. This can be best achieved by adopting the position that one must fulfill obligations or duties that respect moral or human rights and legal or contract[20] rights. Furthermore, it can only be achieved if individuals act with "enlightened self-interest" rather than pure self-interest. Under enlightened self-interest, the interests of individuals are taken into account in decisions—they are not simply ignored or overridden. Individuals are considered "ends" rather than used as "means" to achieve an end or objective.

The concepts of fair treatment and impartiality are fundamental to the development of the concepts of distributive, retributive, or compensatory justice. John Rawls developed a set of principles of justice involving expectations for equal civil liberty, maximization of benefits to the least advantaged, and the provision of fair opportunities (Rawls, 1971). His approach utilized the concept of a "veil of ignorance" to simulate conditions of uncertainty to enable decision makers to evaluate the impact of their actions on themselves. Decision makers were to decide on the best action without knowing if they would be the ones benefiting or losing by it.

Action based on duty, rights, and justice considerations are particularly important to professionals, directors, and executives who are expected to fulfill the obligations of a fiduciary. These would include actions that maintain the trust of a client of someone reliant on the more-knowledgeable, expert professional to act in the client's best interest with regard to matters of considerable

[17] Charles D. Kay, "Notes on Deontology, 1997, http://www.webs.wofford.edu/kayed/ethics/deon.htm.

[18] "Will" can be taken to mean "wish, want, desire, or intend."

[19] Kant foresaw, however, that an individual might "will" bad consequences on others such as by willing euthanasia on everyone. He sought to avoid such ill will affects by further specifying that individuals be always considered "ends" rather than "means," and that an individual's freedom and their ability to choose freely should be respected.

[20] Legal and contract rights are those protected by law, regulation, and/or contract.

value. The professional accountant, for example, has a duty to act in the client's best interest provided such action does not contravene the law and/or the codes and guidelines of related professional and regulatory bodies, such as generally accepted accounting principles (GAAP), generally accepted auditing standards (GAAS), Securities and Exchange Commission (SEC), and securities commission regulations. Directors and executives must observe governance laws in order to protect shareholders and other stakeholders as noted in Chapter 3. These duties must supersede self-interest, bias, and favoritism.

Unfortunately, utilitarianism and consequentialism focus on utility and may lead to decisions or acts that ignore, downplay, or circumscribe the justice or fairness of a decision, and its respect for the duties owed to and rights expected by those involved. However, *augmenting the consequentialist approach with a deontological analysis specifically including fair treatment will guard against the situation where the desire for what some consider to be beneficial consequences (or ends) will be allowed to justify to use of illegal or unethical actions (means) to achieve those ends.* For example, a deontological analysis could avoid endangering the health of workers and/or the public in order to minimize the costs of hazardous waste disposal. From a philosophical perspective, as well as from the perspective of damaged investors, workers, and other stakeholders who have suffered from recent financial scandals, unfettered pursuit of self-interest and short-term profit has led to illegal and unethical acts that are regrettable.

For society, protecting some individual rights—to life and health—is usually more important than maximizing the net benefit to all. However, occasionally, such as in times of war or dire emergency, a choice justified by consequential analysis is considered ethically preferential to a choice justified by deontological considerations.

Virtue Ethics

Where the first two approaches emphasized the consequences of actions or duties, rights and principles as a guide to correct moral behavior, virtue ethicists are concerned with the motivating aspects of moral character demonstrated by decision makers. Responsibility—especially culpability or blameworthiness—in both morality and law, has two dimensions: the *actus reus* (guilty act) and the *mens rea* (guilty mind).[21] Consequentialism and deontology, which examine the former, are said to be "act centered" rather than "agent centered," as virtue ethics is.

According to the AACSB,

> Virtue ethics focuses on the character or integrity of the moral actor and looks to moral communities, such as professional communities, to help identify ethical issues and guide ethical action.[22]

Aristotle's central question was: What is the good life and how can I live it (Cafaro, 1998)? The answer evolved to mean that flourishing, excellence, and happiness were criteria for the good life, but there was a continuing debate over whether the focus should be our communities' interests, or our own, or both. Moreover, excellence was said to involve "intellectual, moral and physical excellence, the excellence of human beings and their creations and achievements . . ." which again could be taken individually or in regard to broader communities.

[21] Jack T. Stevenson, in personal correspondence, December 2005.

[22] AACSB, 2004, 12.

The focus of modern[23] virtue ethics is, however, on character virtues that lead to "enlightened self-interest"; it is not just focused on self-serving fulfillment.

Virtues are those character traits that dispose a person to act ethically and thereby make that person a morally good human being. For Aristotle, a virtue allowed a person to make reasonable decisions. Prudence was his key virtue in determining the proper choice between extremes. His other three important or Cardinal virtues were courage, temperance, and justice. For Christian philosophers, these virtues were not sufficient,[24] and they added the theological or Christian virtues of faith, hope, and charity. Other dispositions that are often cited as virtues include: honesty, integrity, enlightened self-interest, compassion, fairness, impartiality, generosity, humility, and modesty.

Virtues need to be cultivated over time so that they become imbedded and are therefore a consistent reference point. "If you possess a virtue, it is part of your character, a trait or disposition that you typically show in action. It is not just something that you are *able* to exhibit, but something that you usually or *dependably* exhibit."[25]

For virtue ethicists, possessing a virtue is a matter of degree. For example, being honest can mean that one tells the truth. But a person's honesty can be considered stronger or of a higher order if she/he deals only with honest people or causes, works for honest companies, has honest friends, raises her/his children to be honest, and so on. Similarly, the reason a person acts virtuously is important. For example, an honest act undertaken to gain a greedy end result is considered to be less virtuous than one taken because it is believed to be the right thing to do to improve society and/or to discharge a duty to another person or organization. A further problem in reaching the fullest levels of virtue is lack of moral or practical wisdom, such as is evident in some acts of overgenerosity, or too much compassion or courage, which can sometimes be harmful.

While the lack of a "right" reason for virtuous action may seem academic, without such a reason some businesspeople or professionals are prone to act for greedy self-interest rather than modern enlightened self-interest, and are likely to commit unethical and/or unethical acts. They represent higher risks of ultimate deception and malpractice because they lack a basic commitment to virtue or professionalism unless it suits their own purpose. Conversely, overvirtuosity may result in emotional acts by executives or employees prior to seeking and receiving full information, or in taking too much risk, or in harming others unnecessarily. Both the lack of virtue and the lack of what Aristotle would call "prudence" constitute ethics risks to good governance.

There are a number of reservations about the strength of virtue ethics as an approach to EDM. For example, virtue ethics has to do with the process of decision making incorporating moral sensitivity, perception, imagination, and judgment, and some claim that this does not lead to easily useful EDM principles. Other criticisms are relevant, however, including that:

- The interpretation of a virtue is culture-sensitive,
- As is the interpretation of what is justifiable or right.
- One's perception of what is right is to some degree influenced by ego or self-interest.

[23] Note that Aristotle's early formulations referred more to personal happiness and pleasure than to enlightened self-interest.

[24] To ensure a union with God upon death.

[25] Jack T. Stevenson, in personal correspondence, December 2005.

A fuller discussion of virtue ethics and the points raised may be found in the work of Rosalind Hursthouse (2003) and Nafsika Athanassoulis (2004).

Further Discussion

These three philosophical approaches—consequentialism, deontology, and virtue ethics—may be explored further through the readings noted at www.thomsonedu.com/accounting/brooks. They provide the basis for the discussion that follows and are operationalized into practical decision aids by using the measurement and concept criteria identified in Figure 5.1.

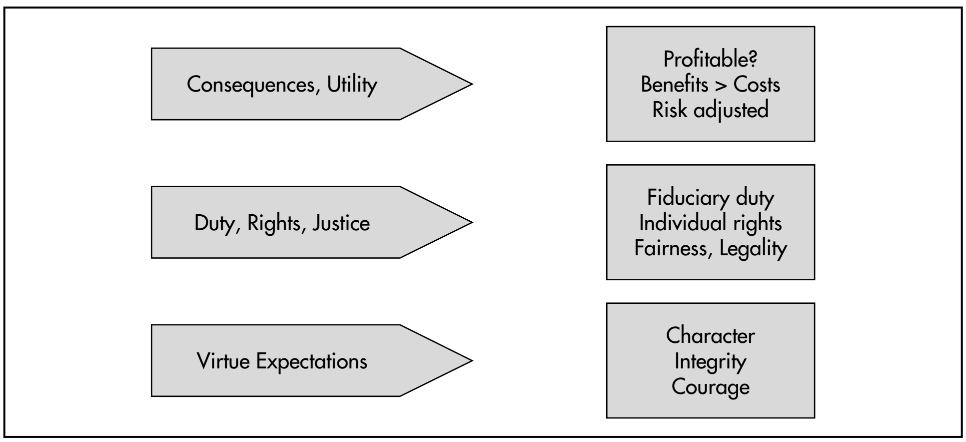
Stakeholder Impact Analysis—A Tool for Assessing Decisions and Actions

Overview

Since John Stuart Mill developed the concept of *utilitarianism* in 1861, an accepted approach to the assessment of a decision and the resulting action has been to evaluate the end results or consequences of the action. To most businesspeople, this evaluation has traditionally been based on the decision's impact on the interests of the company's owners or shareholders. Usually these impacts have been measured in terms of the profit or loss involved, because profit has been the measure of well-offness that shareholders have wanted to maximize.

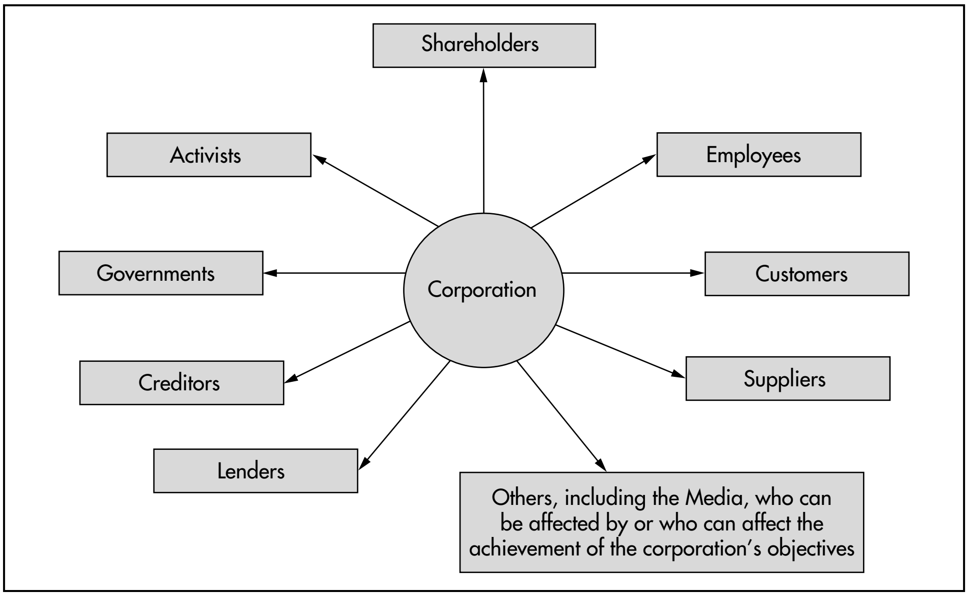
This traditional view of corporate accountability has recently been modified in two ways. First, the assumption that *all* shareholders want to maximize *only* short-term profit appears to represent too narrow a focus. Second, the rights and claims of many nonshareholder groups, such as employees, consumers/clients, suppliers, lenders, environmentalists, host communities, and governments that have a stake or interest in the outcome of the decision, or in the company itself, are being accorded status in corporate decision making. Modern corporations are now accountable to shareholders and to nonshareholder groups, both of which

FIGURE 5.1 EDM Approaches and Criteria



Source: See AACSB EETF Report, June 2004.

FIGURE 5.2 Map of Corporate Stakeholder Accountability



form the set of *stakeholders*[26] to which a company responds (see Figure 5.2). It has become evident that a company cannot reach its full potential, and may even perish, if it loses the support of one of a select set of its stakeholders known as *primary stakeholders*. These ideas on stakeholders and their emerging role are fully developed in Chapter 1.

The assumption of a monolithic shareholder group interested only in short-term profit is undergoing modification because modern corporations are finding their shareholders are also made up of persons and institutional investors who are interested in longer-term time horizons and in how ethically business is conducted. The latter, who are referred to as *ethical investors*, apply two screens to investments: do the investee companies make a profit in excess of appropriate hurdle rates, and do they earn that profit in an ethical manner? Because of the size of the shareholdings of the mutual and pension funds, and other institutional investors involved, corporate directors and executives have found that the wishes of this group can be ignored only at their peril. Ethical investors have developed informal and formal networks through which they inform themselves about corporate activity, decide how to vote proxies, and how to approach boards of directors to get them to pay attention to their concerns in such areas as environmental protection, excessive executive compensation, and human rights activities in specific countries, such as South Africa.

Ethical investors and many other investors, as well as stakeholder groups, tend to be unwilling to squeeze the last ounce of profit out of the current year if it means damaging the environment or the rights of other stakeholders. They believe in managing the corporation on a broader basis than short-term profit only. *Usually, the maximization of profit in a longer than one-year time frame requires*

[26] A stakeholder is anyone who is affected by or can affect the objectives of the organization (Freeman, 1984, 25).

harmonious relationships with most stakeholder groups and their interests. A negative public relations experience can be a significant and embarrassing price to pay for a decision-making process that fails to take the wishes of stakeholder groups into account. Whether or not special interest groups are also shareholders, their capacity to make corporations accountable through the media is evident and growing. The farsighted executive and director will want these concerns taken into account before offended stakeholders have to remind them. *Corporations are finding that in the past they have been legally and pragmatically accountable to shareholders, but they are also becoming increasingly accountable to stakeholders.*

Fundamental Interests of Stakeholders

The multiplicity of stakeholders and stakeholder groups makes it desirable to identify a set of commonly-held interests to be used to focus analyses and decision making on ethical dimensions. Fortunately, decision makers can consolidate the interests of stakeholder groups into the following three commonly held, or fundamental, interests:

1. Their interest(s) should be better off as a result of the decision.
2. The decision should result in a fair distribution of benefits and burdens.
3. The decision *should* not offend any of the rights of any stakeholder, including the decision maker.

The first springs from consequentialism, the second and third from deontology.

To some extent, these fundamental interests have to be tempered by the realities facing decision makers. For example, although a proposed decision should maximize the betterment of all stakeholders, trade-offs often have to be made between stakeholders' interests. Consequently, the incurrence of pollution control costs may be counter to the interests of short-term profits that are of interest to some current shareholders and managers. Similarly, there are times when all stakeholders will find a decision acceptable even though one or more of them, or the groups they represent, may be worse off as a result. In recognition of the requirement for trade-offs and for the understanding that a decision can advance the well-offness of all stakeholders as a group, even if some individuals are personally worse off, this fundamental interest should be modified to focus on the *well-offness* of stakeholders rather than only on their betterment. This modification represents a shift from utilitarianism to consequentialism.

Once the betterment principle is relaxed to become the well-offness principle, the need to analyze the impact of a decision in terms of all three fundamental principles becomes apparent. It is possible, for example, to find that a proposed decision may produce an overall benefit, but the distribution of the burden of producing that decision may be so debilitating to the interests of one or more stakeholder groups that it may be considered grossly unfair. Alternatively, a decision may result in an overall net benefit and be fair, but may offend the rights of a stakeholder and therefore be considered not right. For example, deciding not to recall a marginally flawed product may be cost effective, but would not be considered to be "right" if users could be seriously injured. Consequently, *a proposed decision can be declared unethical if it fails to provide a net benefit,*[27] *is unfair, or*

[27] Unless it is a choice of the least worst of a net negative set of options.

TABLE 5.2 Fundamental Interests of Stakeholders

Well-offness	The proposed decision should result in more benefits than costs.
Fairness	The distribution of benefits and burdens should be fair.
Right	The proposed decision should not offend the rights of the stakeholders and the decision maker.

All three interests must be satisfied for a decision to be considered ethical.

offends the rights of a stakeholder (see Table 5.2). Testing a proposed decision against only one principle is definitely shortsighted, and usually results in a faulty diagnosis.

Measurement of Quantifiable Impacts

Profit

Profit is fundamental to the interests of shareholders and is essential to the survival and health of our corporations. In inflationary times, profit is essential simply to replace inventory at the higher prices required. Fortunately, the measurement of profit is well developed and needs few comments about its use in ethical decision making. It is true, however, that profit is a short-term measure, and that several important impacts are not captured in the determination of profit. Both of these conditions can be rectified in the following sections.

Items Not Included in Profit: Measurable Directly

There are impacts of corporate decisions and activities that are not included in the determination of the profit of the company that caused the impact. For example, when a company pollutes, the cost of cleanup is usually absorbed by individuals, companies, or municipalities that are downstream or downwind. These costs are referred to as *externalities*, and their impact can often be measured directly by the costs of cleanup incurred by others.

In order to see a complete picture of the impacts of a decision, the profit or loss from a transaction should be modified by the externalities it creates. Frequently, corporations that ignore their externalities over time will find that they have underestimated the true cost of the decision when fines and cleanup costs are incurred, or bad publicity emerges.

Items Not Included in Profit: Not Measurable Directly

Other externalities exist where the cost is included in the determination of the company's profit, but where the benefit is enjoyed by persons outside of the company. A donation or scholarship are examples of this kind of externality, and obviously it would be attractive to include an estimate of the benefits involved in the overall evaluation of the proposed decision. The problem is that neither the benefit nor the cost of some negative impacts, such as the loss of health suffered by people absorbing pollution, can be measured directly, but they should be included in an overall assessment.

Although it is impossible to measure these externalities directly, it is possible to measure these impacts indirectly through the use of *surrogates* or mirror image alternatives. In the case of the scholarship, a surrogate for the benefit could be the increase in earnings gained by the recipient. The value of the loss of health could be estimated as the income lost plus the cost of medical treatment plus the loss of productivity in the workplace involved as measured by the cost of fill-in workers.

The accuracy of these estimates will depend on the closeness of the mirror image measure. It is likely, however, that the estimates arrived at will understate the impact involved; in the previous example, no estimate was made for the intellectual gain of the education permitted by the scholarship or the pain and suffering involved as a result of the loss of health. Nevertheless, it is far better to make use of estimates that are generally accurate, rather than make decisions on the basis of direct measures that measure precisely only a fraction of the impact of a proposed decision.

The measurement and use of surrogates to estimate external impacts of corporate decisions is discussed further in the article by Brooks (1979), which appears as a reading at the end of this chapter.

Bringing the Future to the Present

The technique for bringing future impacts of a decision into an analysis is not difficult. It is handled in a parallel manner to capital budgeting analysis, where future values are discounted at an interest rate that reflects the expected interest rates in future years. This approach is demonstrated as part of *cost–benefit analysis* (CBA) in Brooks (1979). Using the net present value approach of capital budgeting analysis, the benefits and costs of a proposed action can be assessed as follows:

$$\begin{array}{c}\text{Net Present Value}\\ \text{of Proposed Action}\end{array} = \text{Present Value of Benefits} - \text{Present Value of Costs}$$

where benefits include revenues and good externalities, and costs include costs plus bad externalities.

Frequently, executives who have learned the hard way to keep their focus on short-term profit will reject the idea of including externalities in their analyses. However, *what is being advocated here is not that they abandon short-term profit as a yardstick, but that they also consider impacts that are now externalities that have an excellent chance of affecting the company's bottom line in the future*. It is likely, for example, that pollution costs will be turned into fines and/or cleanup will be required. Moreover, the advantages bestowed through donations will strengthen society and allow the corporation to reach its full potential in the future. What cost–benefit analysis allows a decision maker to do is to bring these future benefits and costs into the present for a fuller analysis of a proposed decision. For example, Table 2 of the Cost–Benefit Analysis reading (Brooks, 1979) could be reformatted as Table 5.3 to give the decision maker a clearer view of present and possible future impacts on profit.

Dealing with Uncertain Outcomes

Just as in capital budgeting analysis, there are estimates that are uncertain. However, a full range of techniques has been developed to factor this uncertainty into the analysis of proposed decisions. For example, the analysis can be

TABLE 5.3 Cost–Benefit Analysis: Short-And Long-Term Profit Impact

	POLLUTION CONTROL EQUIPMENT *IMPACT ON PROFIT*			UNIVERSITY ADMISSION SCHOLARSHIPS *IMPACT ON PROFIT*		
	Short-Term	*Long-Term*	*Total*	*Short-Term*	*Long-Term*	*Total*
Benefits (Present Valued at 10 percent)						
Reduction in worker health costs		$500,000	$500,000			
Increase in worker productivity	$200,000		200,000			
Improvement in level of productivity, scholarship recipients					$600,000	$600,000
Total benefits	200,000	500,000	700,000		600,000	600,000
Costs (Present valued at 10 percent)						
Pollution equipment	350,000		350,000			
Scholarships paid				$400,000		400,000
Total costs	350,000		350,000	400,000		400,000
Net benefit-costs	($150,000)	$500,000	$350,000	($400,000)	$600,000	$200,000

based upon best estimates, on three possibilities (most optimistic, pessimistic, and best estimate), or on expected values developed from a computer simulation. All of these are *expected values,* which are combinations of a value and a probability of its occurrence. This is normally expressed as follows:

$$\begin{array}{c}\text{Expected Value}\\ \text{of an Outcome}\end{array} = \text{Value of the Outcome} \times \begin{array}{c}\text{Probability of That}\\ \text{Outcome Occurring}\end{array}$$

The advantage of this expected value formulation is that the cost–benefit analysis framework can be modified to include the risk associated with outcomes to be included. This new approach is referred to as *risk–benefit analysis* (RBA), and it can be applied where risky outcomes are prevalent in the following framework:

$$\begin{array}{l}\text{Risk-Adjusted or}\\ \text{Expected Value}\\ \text{of Net Benefits}\end{array} = \begin{array}{c}\text{Expected Present Value}\\ \text{of Future Benefits}\end{array} - \begin{array}{c}\text{Expected Present Value}\\ \text{of Future Costs}\end{array}$$

Identifying Stakeholders and Ranking Their Interests

The measurement of profit, augmented by externalities discounted to the present and factored by riskiness of outcome, is more useful in assessing proposed decisions than profit alone. However, the usefulness of a stakeholder impact analysis depends on the full identification of all stakeholders and their interests, and on a full appreciation of the significance of the impacts on the position of each.

There are occasions, for instance, when the simple adding up of benefits and costs does not fully reflect the importance of a stakeholder or of the impact involved, such as when the capacity of a stakeholder to withstand the impact is low. For example, if a stakeholder is poor, he will not be able to buy remedial treatment, or alternatively his reserves may be so low that other family members—perhaps children—will suffer. On the other hand, a scholarship to a poor recipient could create a benefit for that person and others of significantly greater impact than to a person who is well off. In these situations, the values included in the CBA or RBA can be weighted, or the net present values created can be ranked according to the impact created on the stakeholders involved. The ranking of stakeholders and the impacts on them based on their situational capacity to withstand is also used when nonmeasurable impacts are being considered.

Relative financial strength does not provide the only rationale for ranking the interests of stakeholders. In fact, several more compelling reasons exist, including the impact of the proposed action on the life or health of a stakeholder, or on some aspect of our flora, fauna, or environment that is near a threshold of endangerment or extinction. Usually, the public takes a very dim view of companies that put profits ahead of life, health, or the preservation of our habitat. In addition, making these issues a high priority will often trigger a rethinking of an offending action so as to improve it by removing its offensiveness.

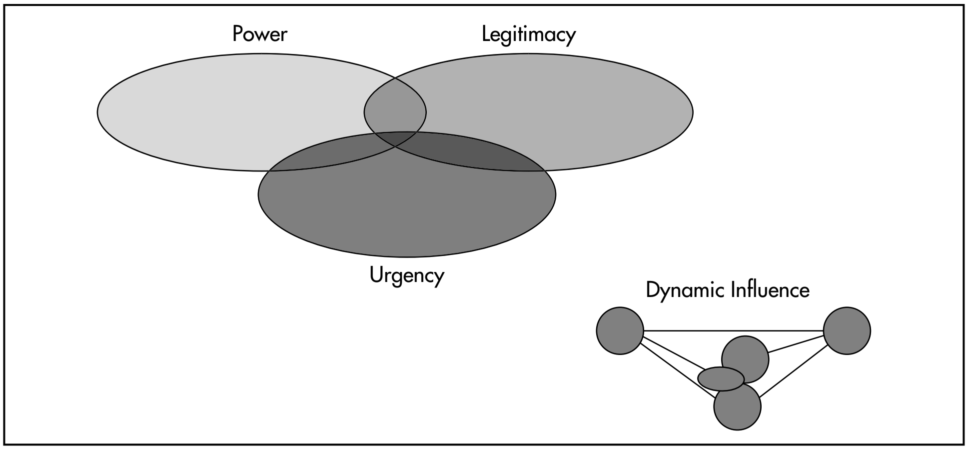
The illustrative *Castle Manufacturing Inc.* case solution provided at the end of this chapter extends the concept of ranking stakeholders to correlate legal rights, financial and psychological capacity to withstand the impact, and the resulting probable public impact of the action. It is interesting that an item may not be "material" to a lay investor in an accounting sense, but may be quite significant to stakeholders. In the long run, such sensitivity to corporate decisions may rebound on the shareholders through the bottom line. In time, the *accounting concept of materiality* as we know it may be inadequate and need to be expanded.

Two research thrusts can prove quite useful in identifying and understanding stakeholder groups and their interactions. Mitchell, Agle, and Wood (1997) suggest that stakeholders and their interests be evaluated on three dimensions: *legitimacy* or legal and/or moral right to influence the organization; *power* to influence the organization through the media, government, or other means; and perceived and real *urgency* of the issues arising. Such an analysis forces the consideration of impacts thought to be very damaging (particularly to external stakeholders) to the fore, so that if an executive decides to go ahead with a suboptimal plan, at least the potential downside will be known. The three sets of claims are identified in Figure 5.3.

Logic suggests that claims where the three circles overlap in Figure 5.3 (i.e., legitimate and/or viewed as legitimate, urgent, and are held by the powerful) will always be the most important. However, this is not necessarily the case. Other urgent stakeholder claims can become the most important if they garner more support of the powerful and those with legitimate claims, and are ultimately seen to have legitimacy.

Many executives forget that an organization's stakeholders change over time, as does the power they wield depending on the urgency they feel about issues brought to their attention. In real life, stakeholders without legitimacy or power will try to influence those with clout, and they succeed. Another researcher, Tim Rowley (1997), has suggested that a set of stakeholders be considered as a *dynamic network*, and that projections be made about who in the network will influence whom, to forecast which issues and interests will become more important. These concepts are developed in the illustrative case *Bribery or Opportunity in China,* located at the end of the chapter.

FIGURE 5.3 Stakeholder Identification and Interests



Sources: Mitchell, Agle, and Wood, 1997; Rowley, 1997.

TABLE 5.4 Approaches to the Measurement of Quantifiable Impacts of Proposed Decisions*

A. Profit or loss only
B. A. plus externalities,
(i.e. Cost–Benefit Analysis/CBA)
C. B. plus probabilities of outcomes,
(i.e. Risk–Benefit Analysis/RBA)
D. CBA or RBA plus ranking of stakeholders

*Optimal decisions usually result from the most thorough approach.

Summary

The previously discussed approaches to the measurement of impacts of proposed decisions are summarized in Table 5.4.

Assessment of Nonquantifiable Impacts

Fairness Among Stakeholders

Although the expectation of fair treatment is a right that individuals and groups can properly expect to receive, it is treated here on its own because of its importance to ethical decision making. The concern for fair treatment has been evident in society's recent preoccupation with such issues as discrimination against women and other matters of hiring, promotion, and pay. Consequently, a decision will be considered unethical unless it is seen to be fair to all stakeholders.

Fairness is not an absolute concept. It is evidenced by a relatively even distribution of the benefits and burdens springing from a decision. For example, it is possible that a decision to increase taxes may weigh more heavily on high-income earners but be seen as relatively fair in terms of their capacity to pay those taxes. Reasonability and perspective are required to judge fairness accurately.

Rights of Stakeholders

A decision will only be considered ethical if its impacts do not offend the rights of the stakeholders impacted upon, and the rights of the person(s) making the decision. This latter point can be seen in the case of a decision being made by executives who subscribe to values that make them offended by child labor or by low standards of worker safety in developing countries. The executives making the decision are stakeholders to it in their own right.

An individual stakeholder or a stakeholder group in North America[28] may generally expect to enjoy the rights listed in Table 5.5.

Some of these rights have been accorded protection under laws and legal regulations, while others are enforced through common law or through public sanction of offenders. For example, employees and consumers are protected under statute for health and safety, whereas dignity and privacy tend to be subject to common law, and the exercise of conscience is subject to public sanction.

In many cases, even where protection is afforded through statute, considerable judgment is required to know when an individual's rights are being violated. Drug testing in the form of urinalysis, for example, appears to be warranted when the health of the worker and fellow workers is at stake, but the degree of jeopardy has to be severe. Airline pilots are considered worthy of urinalysis but, at the moment, drivers of transport trucks are not. There are many reasons for this, including the lack of accuracy and timeliness of the tests, and the stigma that attaches to a false accusation. However, it appears to be reasonable to test a truck driver's reflexes and hand-eye coordination using computer games just prior to his/her shift, so evidently the stigma of failing a computer game related closely to the task to be performed is acceptable in today's society. This complex interplay of statute, regulation, common law, and judgment based on values makes it advisable to give any apparent infringement of a stakeholder's rights very careful scrutiny.

Stakeholder Impact Analysis Decision-Making Approaches

Several approaches have been developed that utilize stakeholder impact analysis to provide guidance about the ethicality of proposed actions to decision makers. Discussions of three follow. Choosing the most useful approach depends on whether decision impacts are short rather than long run, involve externalities

TABLE 5.5

- Life
- Health and safety
- Fair treatment
- Exercise of conscience
- Dignity and privacy
- Freedom of speech

[28] The importance attached to these rights varies somewhat in different cultures around the world.

and/or probabilities, or take place within a corporate setting. The approaches may be blended into a tailored hybrid approach to best cope with a specific situation. *It is imperative to recognize, however, that while each approach deals with the deontological considerations of impacts on rights, fairness, and the duties expected, none incorporate a thorough review of the motivation for the decisions involved, or the virtues or character traits expected in the modern stakeholder accountability era. A comprehensive ethical analysis must therefore go beyond the Tucker, Velasquez, and Pastin models developed below to incorporate an assessment of the motivation, virtues, and character traits exhibited in comparison with those expected by stakeholders.*

5-Question Approach

The 5-question approach, or 5-box approach, as Graham Tucker has called it, in a reading at the end of this chapter, involves the examination or challenge of a proposed decision through the five questions in Table 5.6. The proposed decision is to be challenged by asking all of the questions. If a negative response is forthcoming (or more than one) when all five questions are asked, the decision maker can attempt to revise the proposed action to remove the negative and/or offset it. If the revision process is successful, the proposal will be ethical. If not, the proposal should be abandoned as unethical. Even if no negative response is forthcoming when the questions are first asked, an effort should be made to improve the proposed action using the five questions as a guide.

The order of asking the questions is not important, but all of the first four questions must be asked to ensure that the decision maker is not overlooking an important area of impact. Some ethical problems are not as susceptible to examination by the 5-question approach as to the other approaches described in following sections. For instance, the first question focuses on profit, which is a substantially less comprehensive measurement tool than cost–benefit analysis and/or risk–benefit analysis, with or without the ranking of stakeholders depending on their ability to withstand the impact of the decision. As it stands, however, the 5-question framework is a useful approach to the orderly consideration of problems without many externalities and where a specific focus is

TABLE 5.6 5-Question Approach to Ethical Decision Making

The following five questions are asked about a proposed decision:

IS THE DECISION	STAKEHOLDER INTEREST EXAMINED
1. profitable?	Shareholders'–usually short-term
2. legal?	Society at large–legally enforceable rights
3. fair?	Fairness for all
4. right?	Other rights of all
5. going to further sustainable development?	Specific rights

Question 5 is an optional question designed to focus the decision-making process on a particular issue of relevance to the organization(s) or decision maker involved.

desired by the decision-process designer. For an expanded treatment of this approach, refer to the reading at the end of the chapter by Graham Tucker (1990).

Moral Standards Approach

The moral standards approach to stakeholder impact analysis builds directly on the three fundamental interests of stakeholders that are identified in Table 5.2. It is somewhat more general in focus than the 5-question approach, and leads the decision maker to a more broadly based analysis of net benefit rather than just profitability as a first challenge of proposed decisions. As a result, it offers a framework that is more suited to the consideration of decisions that have significant impacts outside the corporation than the 5-question framework.

The three standards making up the moral standards approach are listed in Table 5.7. Questions that sprang from each standard and that ought to be applied to each decision are also offered.

As shown in Table 5.7, the satisfaction of the utilitarian principle is examined through a question that focuses on cost–benefit analysis or risk–benefit analysis rather than just profit. Consequently, the full range of options discussed in Table 5.4 can be employed as befits the need.

In addition, as explained in Velasquez (1992), the examination of how the proposed decision respects individual rights looks at the impact of the decision on each stakeholder's rights as noted in Table 5.5, as well as at the process involved. For example, has deception or manipulation been used, or some type of force such as coercion, or has there been some other limit placed on information made available to the individuals impacted upon or upon their freedom to chose a response or limit their redress? If so, their rights have not been respected. One of the interesting questions raised in this connection is whether notification of the intent to undertake an action implies the consent of those individuals impacted upon. Usually, notification does not imply consent unless the notification provides full information, allows time for consideration, and reasonable options are at hand to avoid the impact.

TABLE 5.7 Moral Standards Approach to Ethical Decision Making*

MORAL STANDARD	QUESTION OF PROPOSED DECISION
Utilitarian:	
Maximize net benefit to society as a whole	Does the action maximize social benefits and minimize social injuries?
Individual rights:	
Respect and protect	Is the action consistent with each person's rights?
Justice:	
Fair distribution of benefits and burdens	Will the action lead to a just distribution of benefits and burdens?

*All three moral standards must be applied: none is a sufficient test by itself.

The question focusing on distributive justice, or fairness, is handled in the same way as in the 5-question approach. For a full treatment of the moral standards approach, see *Business Ethics: Concepts and Cases* by Manuel G. Velasquez, (1992).

Pastin's Approach

In his book, *The Hard Problems of Management: Gaining the Ethical Edge*, Mark Pastin (1986) presents his ideas on the appropriate approach to ethical analysis, which involves examining the four key aspects of ethics noted in Table 5.8.

Pastin uses the concept of *ground rule ethics* to capture the idea that individuals and organizations have ground rules or fundamental values that govern their behavior or their desired behavior. If a decision is seen to offend these values, it is likely that disenchantment or retaliation will occur. Unfortunately, this could lead to the dismissal of an employee who acts without a good understanding of the ethical ground rules of the employer organization involved. In order to understand the prevailing ground rules, to correctly gauge the organization's commitment to proposals and to protect the decision maker, Pastin suggests that an examination of past decisions or actions be made. He calls this approach *reverse engineering* a decision, because an attempt is made to take past decisions apart to see how and why they were made. Pastin suggests that individuals are often guarded (voluntarily or involuntarily) about expressing their values, and that reverse engineering offers a way to see, through past actions, what their values are.

In his concept of *end-point ethics*, Pastin suggests employing the full extent of the treatments summarized in Table 5.4. The application of these techniques to the Ford Pinto Case (which appears at the end of this chapter) should illuminate the concept of utilitarianism and illustrate the pitfalls of focusing an analysis on only short-term profit.

The concept of *rule ethics* is used to indicate the value of rules that spring from the application of valid ethical principles to an ethical dilemma. In this case, the valid ethical principles involve the respect for and protection of the rights of individuals as are discussed in Table 5.5, and derivative principles such as the golden rule of "Do unto others as you would have them do unto you." The establishment

TABLE 5.8 Pastin's Approach to Stakeholder Impact Analysis

KEY ASPECT	PURPOSE FOR EXAMINATION
Ground rule ethics	To illuminate an organization's and/or an individual's rules and values
End-point ethics	To determine the greatest net good for all concerned
Rule ethics	To determine what boundaries a person or organization should take into account according to ethical principles
Social contract ethics	To determine how to move the boundaries to remove concerns or conflicts

of rules based on respect for individual rights can prove helpful when an interpretation is particularly difficult, or when senior executives want to remove ambiguity about what they believe should be done in certain situations. For example, Pastin suggests that rules, formulated by senior executives to assist their employees, can divide possible actions into those that are obligatory, prohibited, or permissible. Similarly, rules can be crafted so as to make them categorical (i.e., no exceptions allowed) or prima facie (exceptions are allowed in certain circumstances), or to trigger consultation with senior executives. As such, rule ethics represent Pastin's examination of the impact of proposed decisions on the rights of the individuals involved.

The concept of fairness is incorporated by Pastin into his idea of *social contract ethics*. Here he suggests that formulating the proposed decision into an imaginary contract would be helpful because it would allow the decision maker to change places with the stakeholder to be impacted upon. As a result, the decision maker could see if the impact was fair enough to enter freely into the contract. If the decision maker found that he or she was not prepared to enter into the contract with the roles reversed, then the terms (or boundaries) of the contract should be changed in the interests of fairness. This technique of role reversal can prove to be quite helpful, particularly in the case of strong-willed executives who are often surrounded by "yes" men or women. In the case of a real contract, this approach can be useful in projecting how proposed actions will affect the contract, or whether a contract change (such as in a union contract) will be resisted.

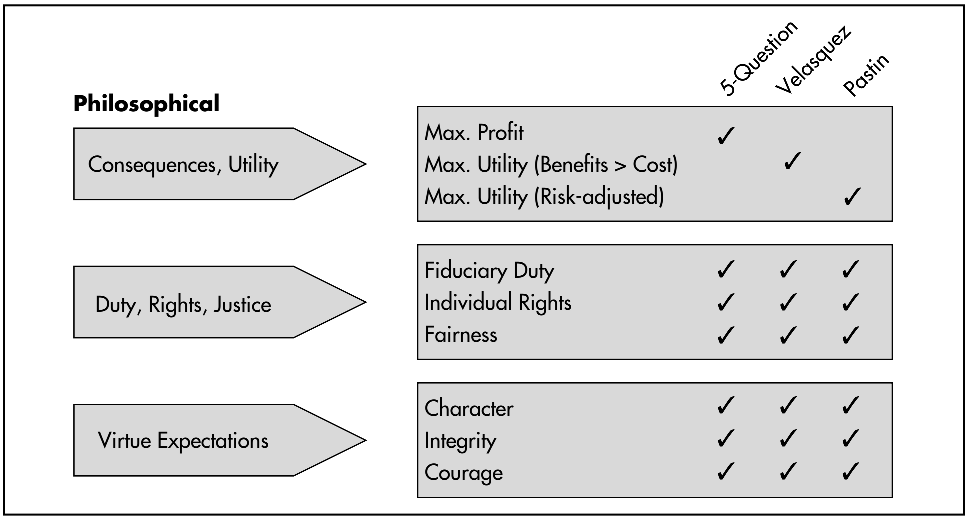
Extending and Blending the Approaches

From time to time, an ethical problem will arise that does not fit perfectly into one of the approaches described. For instance, the issues raised by an ethical problem may be examined by the 5-question approach, except that there are significant long-term impacts or externalities that call for cost–benefit analysis rather than profitability as a first-level question. Fortunately, cost–benefit analysis can be substituted or added to the approach to enrich it. Similarly, the concept of ground rule ethics can be grafted onto a non-Pastin approach, if needed in a decision that deals with an in-company setting. Care should be taken when extending and blending the approaches, however, to ensure that each of the areas of well-offness, fairness, and impact on individual rights are examined in a comprehensive analysis—otherwise the final decision may be faulty.

Integrating Philosophical and Stakeholder Impact Analysis Approaches

The philosophical approaches—consequentialism, deontology, and virtue ethics—that were developed early in the chapter underlay, and should be kept in mind to inform and enrich, the analysis when using the three stakeholder impact approaches. In turn, the stakeholder impact analysis approach used should provide an understanding of the facts, rights, duties, and fairness involved in the decision or act that are essential to a proper ethical analysis of the motivations, virtues, and character traits expected. Consequently, in an effective, comprehensive analysis of the ethicality of a decision or proposed action, the traditional philosophical approaches should augment the stakeholder models, and vice versa, as shown in Figure 5.4.

FIGURE 5.4 Ethical Decision-making Approaches



Source: See AACSB EETF Report, June 2004.

Assessing Motivation, and Expected Virtues and Character Traits

Why Consider Motivation and Behavioral Expectations?

As previously noted, a comprehensive ethical analysis must go beyond the Tucker, Velasquez, and Pastin models to incorporate an assessment of the motivation, virtues, and character traits involved in comparison with those expected by stakeholders.

Virtue expectations, however, have not yet been widely recognized as important in stakeholder analysis, as recent scandals suggest they should be. Decisions made by corporate executives and by accountants and lawyers involved in the Enron, Arthur Andersen, WorldCom, Tyco, Adephia, and others have shown that many decision makers failed to live up to stakeholder expectations. Some were motivated by greed rather than by enlightened self-interest focused on the good of all. Others went along with unethical decisions because they did not recognize that they were expected to behave differently and had a duty to do so. Some reasoned that since everyone else was doing something similar, how could it be wrong? *The point is that they forgot to consider sufficiently the virtues (and duties) they were expected to demonstrate.* Where a fiduciary duty was owed to future shareholders and other stakeholders, the virtues expected—character traits such as integrity, professionalism, courage, and so on—were not taken into account sufficiently. *Therefore it would be wise to include the assessment of virtue ethics expectations as a separate step in any EDM process to strengthen governance systems and guard against unethical, short-sighted decisions.*

It is evident that employees who continually make decisions for the wrong reasons—even if the right consequences result—can represent a high governance risk. Many examples exist where executives motivated solely by greed have slipped into unethical practices, and others have been misled by faulty incentive systems. Sears Auto Center managers were selling repair services that customers did not need to raise their personal commission remuneration, and ultimately caused the company to lose reputation and future revenue.[29] Many of the recent financial scandals were caused by executives who sought to manipulate company profits to support or inflate the company's share price in order to boost their own stock option gains. Motivation based too narrowly on self-interest can result in unethical decisions when proper self-guidance and/or external monitoring is lacking. Since external monitoring is unlikely to capture all decisions before implementation, it is important for all employees to clearly understand the broad motivation that will lead to their own and their organization's best interest from a stakeholder perspective. Consequently, decision makers should take motivations and behavior expected by stakeholders into account specifically in any comprehensive EDM approach, and organizations should require accountability by employees for those expectations through governance mechanisms.

Ethical Assessment of Motivation and Behavior

During the earlier discussion of virtue ethics, several aspects of ethical behavior were identified as being indicative of *mens rea* (a guilty mind), which is one of the two dimensions of responsibility, culpability, or blameworthiness. While some of the virtues named by philosophers may not resonate with modern stakeholders, those listed in Table 5.9 do play a role in framing current expectations for ethical business behavior. If personal or corporate behavior does not meet these expectations, there will probably be a negative impact on reputation and the ability to reach strategic objectives on a sustained basis in the medium and long term.

The stakeholder impact assessment process will offer an opportunity to assess the motivations that underly the proposed decision or action. While it is

TABLE 5.9 Expected Motivations, Virtues, and Character Traits

Motivations expected:
- Self-control rather than greed
- Fairness or justice considerations
- Kindness, caring, compassion, and benevolence

Virtues expected:
- Dutiful loyalty
- Integrity and transparency
- Sincerity rather than duplicity

Character Traits expected:
- Courage to do the right thing according to personal and/or professional standards
- Trustworthiness
- Objectivity, impartiality
- Honesty, truthfulness
- Selflessness rather than selfishness
- Balanced choices between extremes

[29] See Sears Auto Centers cases at http://harvardbusinessonline.hbsp.harvard.edu/b02/en/common/item_detail.jhtml?id=394009

unlikely that an observer will be able to know with precision the real motivations that go through a decision maker's mind, it is quite possible to project the perceptions that stakeholders will have of the action. In the minds of stakeholders, perceptions will determine reputational impacts whether those perceptions are correct or not. Moreover, it is possible to infer from remuneration and other motivational systems in place whether the decision maker's motivation is likely to be ethical or not.

In addition to projecting perceptions and evaluating motivational systems, the decisions or actions should be challenged by asking questions about each of the items listed in Table 5.9. For example,

> *Does the decision or action involve and exhibit the integrity, fairness, and courage expected?*

Alternatively,

> *Does the decision or action involve and exhibit the motivation, virtues, and character expected?*

The objective of these techniques should be to construct a profile about the motivations, virtues, and character traits involved with and exhibited by the decision or action that can be compared to those expected. *The resulting virtue ethics gap analysis is an essential consideration in a comprehensive EDM analysis—see Table 5.10—designed to produce ethically defensible decisions and actions, and improve governance processes.*

Other Ethical Decision-Making Issues

Commons Problems

The term *commons problem* refers to the inadvertent or knowing overuse of jointly owned assets or resources. The concept first arose when villagers in old England overgrazed their livestock on land that was owned in common, or

TABLE 5.10 A Comprehensive Approach to EDM

CONSIDERATION	DESCRIPTION
Well-offness or Consequentialism	The proposed decision should result in more benefits than costs.
Rights, duty or Deontology	The proposed decision should not offend the rights of the stakeholders, including the decision maker.
Fairness or Justice	The distribution of benefits and burdens should be fair.
Virtue expectations or Virtue Ethics	The motivation for the decision should reflect stakeholders' expectations of virtue.

All four considerations must be satisfied for a decision to be considered ethical.

jointly with everyone else in the village, and the term *commons* was used to identify this type of pasture.

The problem of overgrazing could not be stopped because everyone had a right to use the pasture and thus could not be prevented from doing so. Only when the majority of villagers agreed to regulate the commons did the overgrazing stop. Sometimes, when they could not agree, outside authority was called upon to settle the matter. Outdated though these issues seem, the problem of the commons is still with us in modern times. For example, pollution represents the misuse of the environment, a commons we all share. Similarly, if everyone in a business attempts to draw on capital funds, or an expense budget, or a service department, the result will be akin to overgrazing.

The lesson to be learned from this is that frequently the decision maker, who is not sensitized to the problem of the commons, will not attribute a high enough value to the use of an asset or resource, and therefore make the wrong decision. Awareness of the problem should correct this and improve decision making. If an executive is confronted by the overuse of an asset or resource, they will do well to employ the solutions applied in olden times.

Developing a More Ethical Action

Iterative improvement is one of the advantages of using the proposed EDM framework. Using the set of philosophical approaches, the 5-question approach, the moral standards, Pastin, or commons approaches allows the unethical aspects of a decision to be identified, and then iteratively modified to improve the overall impact of the decision. For example, if a decision is expected to be unfair to a particular stakeholder group, perhaps the decision can be altered by increasing the compensation to that group, or by eliminating or replacing the offending words, image, or specific action. At the end of every EDM approach, there should be a specific search for a win-win outcome. This process involves the exercise of *moral imagination*.

Occasionally, directors, executives, or professional accountants will suffer from *decision paralysis* due to the complexities of analysis or the inability to determine the maximal choice for reasons of uncertainty, time constraints, or other causes. Herbert Simon[30] proposed the concept of *satisficing* to solve this problem. He argued that one "should not let perfection be the enemy of the good"—iterative improvement until no further progress can be made should yield a solution that should be considered good enough and even optimal at that point in time.

Avoiding common ethical decision-making pitfalls is imperative. Experience has shown that unaware decision makers repeatedly make the following mistakes:

- *Focusing on short-term profit and shareholder only impacts.* Often, the most significant impacts (for nonshareholder stakeholders) of a proposed action are those that surface in the future and those that befall nonshareholder stakeholders first. Only after these groups react do shareholders bear the cost for misdeeds. The remedy for this myopia is to ensure an adequate time horizon for the analysis, and to take into account externalities on a cost–benefit basis even though the impact measured is felt initially by a nonshareholder group.
- *Focusing only on legalities.* Many managers are only concerned with whether an action is legal. They argue, "If it's legal, it's ethical." Unfortunately, many find

[30] Herbert Simon coined the term satisficing in 1957. See http://en.wikipedia.org/wiki/Satisficing.

their corporation unnecessarily subject to consumer boycotts, employee slowdowns, increasing government regulation to cover loopholes, and fines. Some don't care because they are only intending to stay at this corporation for a short while. The fact is that laws and regulations lag behind what society wants, but reaction does come and sometimes well before new laws and regulations are promulgated. One reason is that corporations lobby against such rule changes. Just because a proposed action is legal does not make it ethical.

- *Limits to fairness.* Sometimes decision makers want to be fair only to groups they like. Unfortunately for them, they do not have the ability to control public opinion and usually end up paying for their oversight. Many executives have been put off by activist organizations such as Greenpeace, but have learned that environmental issues are ignored at their peril. A full review of fairness to all stakeholders is the only way to ensure an ethical decision.
- *Limits to rights canvassed.* Bias is not restricted to fairness. Decision makers should canvass the impact on all rights for all stakeholder groups. Also, decision makers should be encouraged to take their own values into account when making a decision. Courts in North America no longer react favorably to the defense that, "I was ordered to do it by my boss." Employees are expected to use their own judgment, and many jurisdictions have set up protective whistle-blowing and "right to refuse" statutes to encourage employees to do so. Often, managers that force unfortunate actions on subordinates are really not speaking in the best interests of shareholders anyway.
- *Conflicts of interest.* Bias based on prejudice is not the only reason for faulty assessments of proposed actions. Judgment can be clouded by conflicting interests—the decision maker's personal interest versus the corporation's best interest, or the interests of a group the decision maker is partial to versus the corporation's best interest can both account for erroneous assessments and decisions.
- *Interconnectedness of stakeholders.* Often decision makers fail to anticipate that what they do to one group will redound to trigger action by another. For example, despoiling the environment in a far-off country can cause negative reactions by domestic customers and capital markets.
- *Failure to identify all stakeholder groups.* The need to identify all stakeholder groups and interests before assessing the impacts on each is self-evident. However, this is a step that is repeatedly taken for granted, with the result that important issues go unnoticed. A useful approach to assist with this problem is to speculate on the downside that might happen from the proposed action, and try to assess how the media will react. This often leads to the identification of the most vulnerable stakeholder groups.
- *Failure to rank the specific interests of stakeholders.* The common tendency is to treat all stakeholder interests as equal in importance. However, those that are urgent usually become the most important. Ignoring this is truly shortsighted, and may result in a suboptimal and unethical decision.
- *Leaving out well-offness, fairness, or rights.* As previously pointed out, a comprehensive ethical decision cannot be made if one of these three aspects is overlooked. Repeatedly, however, decision makers short-circuit their assessments and suffer the consequences.
- *Failure to consider the motivation for the decision.* For many years, businesspeople and professionals weren't concerned about the motivation for an action, as long as the consequences were acceptable. Unfortunately, many decision makers lost sight

of the need to increase overall net benefits for all (or as many as possible), and made decisions that benefited themselves, or only a select few, in the short run and disadvantaged others in the longer run. These shortsighted, purely self-interested decision makers represent high governance risks for organizations.

- *Failure to consider the virtues that are expected to be demonstrated.* Board members, executives, and professional accountants are expected to act in good faith and discharge the duties of a fiduciary for people relying on them. Ignoring the virtues expected of them can lead to dishonesty, lack of integrity in the preparation of reports, failure to act on behalf of stakeholders, and failure to discharge courage in confronting others who are involved in unethical acts, or in whistle-blowing when needed. Professional accountants who ignore virtues expected of them are prone to forget that they are expected to protect the public interest.

A Comprehensive Ethical Decision-Making Framework

For the previously noted reasons, *a comprehensive EDM approach should include all four of the considerations outlined in Table 5.10.*

All four considerations can be examined within a philosophical analysis, a stakeholder impact analysis, or a hybrid analysis. The best EDM approach will depend upon the nature of the proposed action or ethical dilemma and the stakeholders involved. For example, a problem involving short-term impacts and no externalities may be best suited to a 5-question analysis. A problem with longer-term impacts and/or externalities is probably better suited to a moral standards approach, or Pastin's approach. A problem with significance for society rather than a corporation would likely be best analyzed using a philosophical approach, or the moral standards approach. Whatever the EDM approach used, the decision maker must consider all of the fundamental issues raised in Table 5.1 and articulated in Table 5.10.

Summary of Steps for an Ethical Decision

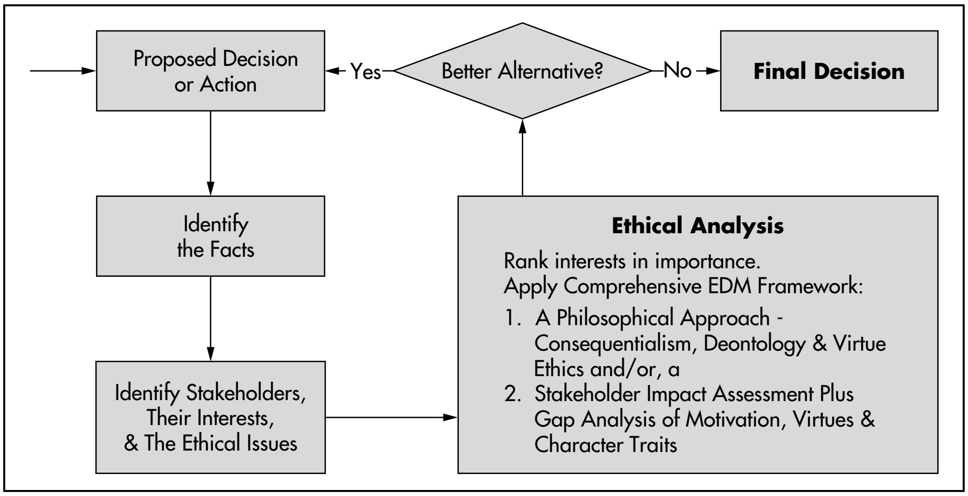
The approaches and issues previously discussed can be used independently or in hybrid combination to assist in producing an ethical decision. Experience has shown that completing the following three steps provides a sound basis for challenging a proposed decision.

1. *Identify* the facts and all stakeholder groups and interests likely to be affected.
2. *Rank* the stakeholders and their interests, identifying the most important and weighting them more than other issues in the analysis.
3. *Assess the impact* of the proposed action on each stakeholder group interests with regard to their well-offness, fairness of treatment, and other rights, including virtue expectations, using a comprehensive framework of questions, and making sure that the common pitfalls discussed later do not enter into the analysis.

It may be helpful to organize an ethical decision analysis using the seven steps outlined by the American Accounting Association (1993) as follows:

1. Determine the facts—what, who, where, when, and how.
2. Define the ethical issue(s).
3. Identify major principles, rules, and values.

FIGURE 5.5 Steps Toward an Ethical Decision



4. Specify the alternatives.
5. Compare values and alternatives, and see if a clear decision emerges.
6. Assess the consequences.
7. Make your decision.

Steps toward an ethical decision are summarized in Figure 5.5.

Conclusion

Stakeholder impact analysis offers a formal way of bringing into a decision the needs of an organization and its individual constituents (society). Trade-offs are difficult and can benefit from such advances in technique. It is important not to lose sight of the fact that the concepts of stakeholder impact analysis that are reviewed in this chapter need to be applied not as single techniques but together as a set. Only then will a comprehensive analysis be achieved and an ethical decision made. Depending on the nature of the decision to be faced, and the range of stakeholders to be affected, a proper analysis could be based on consequentialism, deontology, and virtue ethics as a set, or within one of the 5-question, moral standards, or Pastin's approaches, taking into account the possible existence of commons problems that might arise. Any comprehensive EDM approach must include not only an examination of the impacts of the decision or action, but also a gap analysis of the motivations, virtues, and character traits involved.

A professional accountant can use stakeholder analysis in making decisions about accounting, auditing, and practice matters, and should be ready to prepare or assist in such analyses for employers or clients just as is currently the case in other areas. While many hard-numbers-oriented executives and accountants will be wary of becoming involved with the "soft" subjective analysis that typifies stakeholder and virtue expectations analysis, they should bear in mind that the world is changing to put a much higher value on nonnumerical information. They should beware of placing too much weight on numerical analysis lest they fall into the trap of the economist, who, as Oscar Wilde put it: "knew the price of everything and the value of nothing."

Directors, executives, and accountants should also understand that the techniques discussed in this chapter offer a means of better understanding the interplay between their organization and/or profession and its potential supporters. The assessment of impacts on stakeholders when combined with the ranking of each stakeholder's ability to withstand the action will lead to the better achievement of strategic objectives based upon satisfied stakeholders. Operating successfully in an increasingly demanding global network of stakeholders will require that future actions are not only legal, but also ethically defensible.

QUESTIONS

1. Why should directors, executives, and accountants understand consequentialism, deontology, and virtue ethics?
2. Prior to the recent financial scandals and governance reforms, few corporate leaders were selected for their "virtues" other than their ability to make profits. Has this changed, and if so, why?
3. Is it wise for a decision maker to take into account more than profit when making decisions that have a significant social impact? Why?
4. If a framework for ethical decision making is to be employed, why is it essential to incorporate all four considerations of well-offness, fairness, individual rights and duties, and virtues expected?
5. Is the 5-question approach to ethical decision making superior to the moral standards or Pastin approach?
6. Under what circumstances would it be best to use each of the following frameworks: the philosophical set of consequentialism, deontology, and virtue ethics; the 5-question; the moral standards; and the Pastin approach?
7. How would you convince a CEO not to treat the environment as a cost-free commons?
8. How can a decision to downsize be made as ethical as possible by treating everyone equally?

CASE AND ILLUSTRATIVE APPLICATION INSIGHTS

- *Bribery or Opportunity in China*—an illustrative application—is a real-life example of how a young executive faced the realities of business abroad, and how he came to an innovation solution.
- *Proposed Audit Adjustment?*—an illustrative application—describes the thinking involved in proposing an adjustment to year-end audited financial statements.
- *When Does an "Aggressive Accounting" Choice Become Fraudulent?*—an illustrative application—is provided to indicate how the fundamental interests of stakeholders described in Table 5.2 ought to generate issues to be considered in a stakeholder impact analysis on the topic of accounting choices.

- *Vioxx Decisions—Were They Ethical?*—provides an opportunity for students to research a serious dilemma that is currently in the news and develop a comprehensive, practical ethical analysis of the decisions faced by Merck, the manufacturer, which now faces over 9,000 lawsuits and 18,000 plaintiffs. Students will also consider how the current dilemma could have been avoided.
- *Just Do It—Make the Numbers!* CFOs are often influenced, ordered or coerced to bend the rules to make financial results better and often equal to prior projections released to the public. It's not an easy decision when your demanding boss is standing over you. What should a professional accountant consider before doing so?
- *Smokers are Good for the Economy—Really* presents an argument that is counterintuitive in that cigarette smoking can be good. Does this actuarial/economics-based argument take into account all that a comprehensive ethical analysis should?
- *The Ford Pinto* case is a classic that shows in stark relief the danger of ignoring the social impacts of a decision in favor of maximizing short-run profit. The original cost–benefit analysis was quite faulty, and our appreciation of safety has changed a lot since the Pinto was created, but the same problems continue to recur.
- *Kardell Paper* involves the possible pollution of a river with potentially life-threatening consequences. In addition to dealing with uncertainty, the reader learns to appreciate issues such as whistle-blowing, representative corporate governance at the board level, and due diligence requirements on the part of executives and board members.

READING INSIGHTS

The two readings that are provided for this chapter are intended to offer the reader further elaboration on cost–benefit analysis and the 5-question approach to ethical decision making.

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ILLUSTRATIVE APPLICATION OF STAKEHOLDER IMPACT ANALYSIS

Bribery or Opportunity in China Case

Note: Names have been changed

John Low, a North American born of Chinese descent, was given the opportunity of his lifetime. He was asked to go to China and set up a manufacturing subsidiary in a medium sized city in the middle of the country. He had arrived in the city and had attempted to set up a new building and manufacturing facility which would employ thirty people, but had run into many delays in dealings with the local authorities. Ultimately, John met with the three senior officials and asked what the problem was. They indicated that things would go a lot faster if John's company was to make them a payment of $100,000 each. This, they said, was quite reasonable in view of what other companies had been paying.

John was in a quandary. When he had been sent to China, his boss had told him that under no circumstances were any bribes to be paid. It was against company policy and it would not be tolerated. On the other hand, John was expected to get his job done, and his boss had told him that unless he did so, another manager would be sent to take over John's position. John knew that his budget contained a provision for payments to agents, but the total allowed was only $150,000. He knew that if the facility was delayed, every month of delay would cost his company a contribution of approximately $25,000. John told the senior officials repeatedly that there was no way his company would pay them, but they were insistent.

Questions

1. Should John pay the bribes?
2. Is there something else he could do instead?

Illustrative Solution

The first step in a stakeholder impact analysis is to identify all stakeholder groups affected by the proposed action and their interests. At the end of the identification process, the stakeholders and their interests are to be ranked in importance. These two steps can be facilitated by means of a tabular analysis as follows:

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Analysis of Stakeholders and Their Interests

STAKEHOLDER	INTEREST	LEGITIMACY/ LEGAL INFLUENCE	POWER TO AFFECT CO.	URGENCY OF CLAIM	PRIMARY OR SECONDARY	RANK IN IMPORTANCE: 1 IS HIGHEST, 3 IS LOWEST
John	Potential success or dismissal, unless a new idea can be found. Prob. of discovery estimated at 60%	Yes	Yes	High	Primary	1
Local employees	Delay in job, or no job	No	Not yet	Low	Secondary for now	3
John's boss	John's success is his own, but he runs the risk of sanction if John is found to have bribed	Yes	Yes	High, but less than John's	Primary	2
Other managers elsewhere	Company policy will be eroded, so observance will be difficult, since employees will know of breach	Yes	Yes	Medium	Primary	2
Shareholders	Financial success earlier, but costs of bribes will raise costs, and will be called for in many situations. Possible fines and bad publicity if caught, and *Foreign Corrupt Practices Act* or similar applies, so profits down, Prob. 40%	Yes	Yes	High	Primary	1
Chinese officials	$300,000 richer if not caught, then? Prob. 10 %	Yes	Yes	Medium/high	Primary	1

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Analysis of Stakeholders and Their Interests—Continued

STAKEHOLDER	INTEREST	LEGITIMACY/ LEGAL INFLUENCE	POWER TO AFFECT CO.	URGENCY OF CLAIM	PRIMARY OR SECONDARY	RANK IN IMPORTANCE: 1 IS HIGHEST, 3 IS LOWEST
Directors and senior executives	Directors same as shareholders. Exec. no bonuses & could be dismissed	Yes	Yes	High, but less than John's	Primary	1
Elderly Chinese in town (leaders in society)	No benefit until local employment starts, or other benefit created	No	Yes, very influential	Low	Appears secondary, but could be primary	1
Chinese government	Bribes raise cost of doing business in China	Yes	Yes, but distant	Low	Secondary for now	3
John's family	Unknown if he has any					Not Applic.

In this situation, with the proposed action being to pay the bribes or not, there aren't many externalities, but there are legalities and company ground rules. Consequently, John could use a hybrid ethical decision framework based upon the 5-question, but with the use of net benefit in addition to profit and ground rule ethics. The questions or challenges for the proposed action are therefore as shown in the table below, with responses noted.

Challenges to Proposed Action: Payment of Bribes

QUESTION OR CHALLENGE	RESPONSE
1. Is it profitable?	Maybe for company. $25K per month × 40% Prob. of being caught—cost of fines and additional bribes elsewhere. John, probably not, as Prob. of being caught is 60%.
2. Is it legal?	Not really, but maybe if creative arrangement with an agent is successful and/or this is considered a facilitating payment, not a bribe.
3. Is it fair?	Not to John, or his boss, or top management, to China, or to elderly Chinese.
4. Is it right? Generally?	Everyone is doing it, so maybe.
Per company ground rules?	Not per company ground rules and code.
Per John?	Not known.
5. Does it provide the highest net benefit for all?	Maybe, unless a better idea is found.

Based on this analysis, John found several responses that were negative or not clearly positive, indicating an unethical—and in this case illegal—decision. Yet, he had to bribe or admit failure unless he could find an ethical alternative.

John also asked himself whether the decision to bribe would involve and exhibit the motivations, virtues and character traits expected. His answers appear in the table below.

Bribery was not in accord with expected motivations, virtues or character traits, so John began to look for other alternatives. He began to consider the primary stakeholders to the company's long-run success in the area. He realized that the company's

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Expected Motivations, Virtues & Character Traits

QUESTION: DOES THE DECISION OR ACTION (TO BRIBE) INVOLVE OR EXHIBIT THE EXPECTED:	RESPONSE
Motivations	Possibly, but higher levels of self-control, fairness, and/or caring may be possible with other alternatives.
Virtues	No. John would be breaching his CEO/company's expectations. Dutiful loyalty, integrity, and sincerity would be below expectations. Duplicity would be required, rather than transparency, to appear to comply with company codes and Chinese law.
Character Traits	No. It is doubtful that John would be considered trustworthy, honest, or truthful if he bribes and is found out.

relationship with the Chinese elderly was going to be of high long-run significance because the elderly are very influential in Chinese culture. What could he do to satisfy the elderly and perhaps bring the local officials on-side as well? At the same time he did not want to offend his company's ground rules which were to observe the code and not to bribe.

He had noticed that there wasn't really a good place for the elderly to gather, like his own parents had back home. In the end, he asked his boss if his company ever supported community centers, and the answer was yes. The company's donations budget would provide the funds and company officials were quite interested in paying for a senior citizens' center and park in the Chinese town as part of the company's good corporate citizen program of supporting the communities that they operated in. John proposed this to the senior Chinese officials who wanted the bribes, indicating that his company would not make such payments directly to anyone. The officials, however, would get credit by association with the park and center and would, of course, serve on the Board of Directors of the Center when it was finished.

John's plant was ready in record time, and he was awarded a citation his company's CEO who was also the person in charge of the company's ethics program. It seemed apparent that he had found a solution that provided the highest net benefit to all—a true win-win-win arrangement—that matched well to expected motivations, virtues and character traits.

ILLUSTRATIVE APPLICATION OF STAKEHOLDER IMPACT ANALYSIS

Proposed Audit Adjustment Case–Castle Manufacturing Inc.

Larry Plant, the Chief Financial Officer of Castle Manufacturing Inc., was involved in a lengthy discussion with Joyce Tang of the company's auditing firm, Bennett & Sange at the conclusion of the audit fieldwork.

"Look Joyce, we just can't afford to show that much profit this year. If we do record the $1.5 million after-tax adjustment you propose, our profit will be 20 percent higher than we had two years ago and 5 percent higher than we reported last year. On the other hand, without the adjustment, we would be close to last year's level. We are just about to enter negotiations with our labor unions, and we have been complaining about our ability to compete. If we show that much profit improvement, they will ask for a huge raise in rates. Our company will become non-competitive due to higher labor rates than our offshore competition. Do you really want that to happen?"

"But Larry, you really earned the profit. You can't just ignore it!"

Continued

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"No, I'm not suggesting that, Joyce. But virtually all of the goods making up the profit adjustment were in transit at our year end—so let's just record them as next year's sales and profits."

"But, Larry, they were all sold FOB your plant, so title passed to the buyer when they were shipped."

"I know that, Joyce, but that was an unusual move by our overzealous sales staff, who were trying to look good and get a high commission on year-end numbers. Anyway, the customer hadn't inspected them yet. Just this once, Joyce, let's put it into next year. It's not really a significant amount for our shareholders, but it will trigger a much bigger problem for them if the unions get a hold of the higher profit numbers. As you know, about 40 percent of our shares were willed to the United Charities Appeal here in town, and they could sure benefit by higher profits and dividends in the future. I bet the difference in their dividends could be up to $400,000 per year over the life of the next five-year contract."

Question

1. What should Joyce do?

Illustrative Solution

Several approaches to ethical decision making are presented in the chapter: the philosophical, or those to be used with an assessment of the motivations, virtues, and character traits—the 5-question approach, the moral standards approach, and the Pastin approach. In this illustrative solution, the 5-question framework will be used, with expansions, where necessary, drawn from other approaches.

The 5-question approach calls for the identification of the stakeholders impacted by the decision and then poses five questions or challenges to assess whether these impacts are ethical or not. If some aspect of the decision is considered not to be ethical, the proposed decision/action may be altered to mitigate or remove the unethical element.

In this case, the auditor has proposed that a $1.5 million adjustment be made to increase the profitability of the client Castle Manufacturing Inc. The CFO is resisting, proposing instead that the impact on profit be put into the next year so as to gain a bargaining advantage over the company's unions, who will use the profit figures to negotiate a new five-year agreement. Joyce Tang, the auditor, must decide whether the proposal to shift the adjustment to the next year is ethical: if not, she must convince the CFO to record the adjustment or qualify her audit report. It is not immediately apparent whether the adjustment is material or not: if it was, the correct action would be to qualify the audit report if the CFO were to hold fast to his proposal.

Identification of Stakeholders and Their Interests

The CFO's proposal would impact on the following stakeholders:

STAKEHOLDERS	INTERESTS
Directly Impacted:	
Current shareholders wishing to sell their shares in the short run	They would want the adjustment recorded in the current year to boost profit and share values.
Current shareholders wishing to hold on to their shares	They would want the adjustment deferred to minimize the labor settlement and maximize future profits and dividends.
Future shareholders	They would want an accurate assessment of profitability to properly assess whether or not to buy into the company. If profits are depressed, they might not buy in, so the increased future profits may not be relevant.
Employees	They would want profits accurately stated to provide a higher basis for negotiation assuming this would not jeopardize the long-run viability of the enterprise.
Company management	Depending on their bonus arrangements and their altruism, they would want short or longer-term recognition of the adjustment.
Directors	They would want the long-run profit improvement, provided they would not be sued for sanctioning something illegal.

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The CFO's proposal would impact on the following stakeholders:—Continued

STAKEHOLDERS	INTERESTS
Creditors, suppliers, and lenders	If the labor negotiations result in higher profitability and liquidity, these stakeholders would want the adjustment deferred.
Governments and regulators	They would want profits accurately stated because this would result in higher taxes and fewer potential complaints from other stakeholders (e.g., unions).
Joyce and her audit firm	They would want to minimize the chance of legal and professional challenges arising from the audit that would result in fines and/or loss of reputation, but they also would wish to continue auditing a healthy client.
Indirectly Impacted:	
Recipients of the funds generated by the United Charities Appeal	They would want the adjustment deferred.
Altruistic management of the United Charities Appeal	They would want the adjustment properly dealt with, which would probably mean that they would side with the employees.
Host communities	They would want the highest labor rate settlement possible without jeopardizing the long-run health of the enterprise.
The auditing profession	It would want to avoid loss of reputation for the profession.

Ranking of Stakeholder's Interests

The stakeholders' interests in the decision identified above can be ranked as to their importance on "possessing legal rights," "ability to withstand both financially and psychologically" (a rank of "1" is worst), and "probable public reaction on behalf of" scales, as follows:

STAKEHOLDERS IMPACTED	POSSESS LEGAL RIGHTS	RANK OF ABILITY TO WITHSTAND	PROBABLE PUBLIC REACTION FOR
Current shareholders—wishing to sell	Yes—first	3	Low
Current shareholders—wishing to hold	Yes—tie	3	Low
Future shareholders	Yes	3	Low
Employees:	No—none	2	Strong
- if contract is GAAP based	Yes	2	Strong
- if financial statement is used in negotiation	Yes—poss.	2	Strong
Company management—dependent on contract	Yes or no	3	Low
Directors	Yes	2	Low
Creditors, suppliers	No	4	Low
Lenders—dependent on contract	No or yes	4	Low
Governments and regulators	Yes	4	Moderate
Joyce and her audit firm	Yes	2	Strong
Recipients of charity funds	No	1	Strong
Altruistic management of charity	No	3 or 2	Strong
Host communities	No	4	Moderate
Auditing profession	No	3	Strong

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It is evident from these rankings that the strength of legal rights does not correspond to the rankings of a stakeholder's ability to withstand the decision or to the probable public reaction on behalf of each stakeholder if the decision to defer the adjustment becomes public. Moreover, the legal rights of stakeholders with differing interests are equal. The "probable public reaction" scale, which corresponds strongly to the "ability to withstand" scale, offers a good idea of how politicians, governments, and regulators will react. Consequently, decision makers would be unwise to focus only on the legality of stakeholder positions.

Of course, the likelihood of the deferment becoming public has to be estimated. Unfortunately, most decision makers overlook the possibility of an altruistic or disgruntled whistle-blower making the disclosure public or, alternatively, revealing it to the union bargaining team. As a result, the valid probability of revelation is usually far higher than the decision maker's assessment.

Application of the 5-Question Approach

Question 1: Profitability

There is no doubt that the deferment of an upward adjustment of $1.5 million to profit will decrease profit this year and increase it the next. In addition, there is some possibility, if the decision doesn't become public or known to the union, that the company's profits over the life of the contract will rise substantially if total dividends will rise by $1.0 million per year ($400,000/40 percent). However, if the decision becomes known, the union may retaliate and bargain harder, lawsuits may be launched against the company, the executives, and the auditors, and governments may levy tax penalties and fines. Consequently, the outcome on the profitability question is uncertain for the company and therefore for its shareholders and their dependants (and for the auditor, for that matter).

Question 2: Legality

Given that the decision to defer the adjustment is in the gray area of Generally Accepted Accounting Principles (GAAP) (it is not clearly material—although it is suspiciously significant—nor is it contravening usual company practice, the customers have not inspected the goods at year end, and it is a conservative treatment), it might be declared reasonable in a court of law. However, the legal process, which usually covers the company, its management and directors, and the auditor as being joint and severally liable, will involve legal fees, expert witness testimony, commitment of time (which soaks up billable time), and the potential of having to pursue other co-defendants for restitution if they are found to be culpable rather than the auditor. Of course, the auditor could mitigate these legal consequences be qualifying her report, but that would obviate the exercise and could create ill will with the CFO and possibly the rest of the management and directors. Because the legal interests do not coincide, and a lawsuit is likely if the deferment is known, the decision maker may not be able to take comfort from the fact that the deferment is probably within the boundaries of GAAP and therefore legal.

Question 3: Fairness

While the decision to defer the $1.5 million adjustment may not be considered material to an investor making the decision to invest or divest, it may be very significant to the employees and their union, and to the charity and its dependents. Consequently, not to disclose the $1.5 million this year may be unfair to these interest groups. If the decision becomes public, this unfair treatment may result in lawsuits and may bring the company, its auditors, and the auditing profession into disrepute with the public. The claim would be that these parties were not acting in the public interest; that the auditors failed to lend credibility to the financial statements and thereby failed to protect the public.

Question 4: Impact on Rights

To the extent that the proposed decision impacted negatively on the rights of stakeholders, in terms of life, health, privacy, dignity, etc. (i.e. rights other than fairness and legal rights which are canvassed in questions 2 and 3), the decision would be considered unethical. In this case, there are no lives at stake, but conceivably the health and well-being of the employees and particularly the ultimate recipients of the charity are at stake. The extent of this infringement would be revealed by further investigation. Given the information in the case, the degree of infringement of stakeholder rights is unclear.

Question 5: Does it contribute favorably to sustainable development and/or survivability?

From the environmental perspective, the deferment decision appears to have nothing to do with the

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PROJECTED	SHORT-TERM PROFIT	FIVE-YEAR PROFIT	COST–BENEFIT ANALYSIS	RISK–BENEFIT ANALYSIS
Revenues/cost savings/ benefits				
Costs/opportunity costs				
Net profit/net benefits	________	________	________	________

company's impact on sustainable development. Also, there is probably no impact on the ability of the company to survive because the $1.5 million adjustment appears to be only 5 percent of the after-tax profit before the adjustment. However, it is unlikely that the deferment could be repeated year after year without offending GAAP.

Summary of Findings of 5-Question Approach

This analysis has shown that the proposed deferment is probably legal but may not be profitable, fair, or respectful of stakeholder's rights. Certainly the examination of just a one-year time frame would have proven to be misleading. Further analysis appears needed to reach a conclusive decision on many issues, and even then reflection will be needed to weigh the trade-offs between interests.

Extensions of the 5-Question Approach

The stakeholder impact challenges inherent in the 5-question approach, the moral standards approach, and Pastin's approach can be grouped into three areas: well-offness, fairness, and rights.

On the dimension of well-offness, it is evident that looking only at the profitability of the decision focuses discussion of the interests of shareholders rather than stakeholders. The way to broaden the focus is to prepare an analysis over a longer rather than shorter time frame so some of the externalities are included; to use cost–benefit analysis to bring in intangibles, such as the loss of quality of life; and to use risk–benefit analysis to include probabilities of occurrences. These enhancements have been included intuitively in the previous analysis but could be sharpened with further investigation and presented formally to the decision maker to assist in their decision, perhaps in the following format see above.

This presentation would allow the decision maker to see what the short-term and longer-term impact on profits was, and what the overall net benefits were likely to be for all stakeholders. Frequently, the benefits and costs accruing to stakeholders ultimately accrue to shareholders, so this presentation will allow a decision maker to project what may result from the decision. In this case, we do not have enough information to develop estimates for the costs and benefits associated with the positions of many stakeholders.

With regard to fairness, the concept of ranking stakeholders on several dimensions has already been employed. If the fairness of an impact is ever in doubt, one way to assess it is to put yourself in the position of the stakeholder being assessed. If you would be willing to change places with the other party, then the decision is probably fair. If not, the decision may be made fair by altering or reengineering its impact in some way.

The consideration of impacts on stakeholder rights can be enhanced beyond the level employed in this analysis by a heightened awareness of commons problems. Sometimes rights shared with others are taken for granted, but they should not be. The environment is one example of this, but there may be others on which specific decisions impact.

Assessment of Motivations, Virtues, and Character Traits Expected

All of the stakeholder impact assessment approaches, or any hybrid approach, should be augmented by an assessment of motivations, virtues, and character traits involved in and exhibited by the decision or action compared to what is expected. In this case, for Joyce Tang, the decision maker, this assessment would be as follows.

Continued

Continued

Expected Motivations, Virtues, and Character Traits

QUESTION: DOES THE DECISION OR ACTION INVOLVE OR EXHIBIT THE EXPECTED:	RESPONSE
Motivations	Possibly not. As a professional accountant, Joyce is supposed to use her unbiased, fair judgment to protect the public interest by following GAAP and her professional accounting code. This protects future shareholders from harmful actions that would benefit existing shareholders.
Virtues	If Joyce's action of lowering profit by $1.5 million becomes known, future shareholders, some current shareholders, and the employees will consider it unethical because Joyce will appear: - to be disloyal to her profession and those shareholders, - to be lacking in integrity and the desire to support transparency, and - duplicitous.
Character Traits	The disenchanted stakeholders will take the view that Joyce is untrustworthy, partial to some stakeholders, and lacking the courage to stand up for the rights of all stakeholders.

In this decision, there doesn't appear to be much room for re-engineering to make its impact more ethical, so it must be faced as it is.

Conclusion

Although the proposed decision appears to hold some promise of profitability, and could be within GAAP and legal, it does not appear to be fair or right to several stakeholders. *Although the proposed action's impact may not be material for investors, it is significant to several stakeholders*. The proposed action does not match expectations for ethical motivations, virtues, or character traits. Consequently, it is somewhat unethical and may result in significant negative reaction for the directors, auditor, and auditing profession. These matters and their consequences should be fully explained to the Audit Committee of the Board of Directors. In the post-Sarbanes-Oxley regime, the Audit Committee should be informed by the auditor of such disputes with management and what the auditor's opinion was. If the Audit Committee agrees with management (whose mandate includes the preparation of the financial statements) to exclude the $1.5 million profit, the full board should be advised and the auditor should consult within her firm to arrive at a consensus position on whether or not to qualify the audit report. In this way, the decision can be shared among those who would be held responsible.

ILLUSTRATIVE APPLICATON OF STAKEHOLDER IMPACT ANALYSIS

When Does An "Aggressive Accounting" Choice Become Fraudulent?

Fraudulent choices of accounting treatment are those which contain such an element of deception that a reasonably informed and careful investor or other financial report user would be misled to his or her detriment as a result. For instance, revenue or expenses may be misstated to improperly increase current profit (thus diminishing future profits) to raise share prices or increase management bonuses.

Continued

Continued

This would put future shareholders at a disadvantage as they would be buying shares at inflated prices while the company's assets would be reduced by the bonus money paid out.

There are, however, times when generally accepted accounting principles (GAAP) allow a choice among alternative treatments where some are more aggressive than others which are considered conservative usually because of their tendency not to inflate current profits. For instance, a company's management may choose different approaches to depreciate its fixed assets which would give rise to different depreciation charges against profit. Similarly, a range of choices is available for accounting for goodwill, or the recognition of warrantee expense, or the recognition of revenue from construction contracts. If these accounting choices are made without consideration of all possible accounting practices, current and future shareholders may not be properly served. However, unless there is an effective ethical framework for deciding which of these choices to make, accounting choices may become too aggressive and fraudulent.

The following ethical framework and issues may be helpful in making choices that are aggressive but not fraudulent.

FUNDAMENTAL STAKEHOLDER INTEREST	ISSUES TO BE CONSIDERED
Well-offness	Are current and future shareholders interests reported clearly and accurately, and as the related economic reality warrants?
Fairness	Are the interests of current shareholders, future shareholders, management or other stakeholders unfairly disadvantaged with the benefit being transferred to another stakeholder?

Right(s)	Are the rights of stakeholders observed, including adherence to:
	• Professional fiduciary focus on duty to the public
	• Professional standards–objectivity, accuracy, integrity, competency, fair presentation
	• GAAP
	• Securities Commissions guidelines for:
	  ▪ Full, true and plain disclosure
	  ▪ Specific disclosures
	• Company policies such as for clarity and completeness?

Virtue Expectation	Motivations, Virtues, Character Traits (see Table 5.9)

ETHICS CASE

On September 30, 2004, Merck voluntary withdrew its rheumatoid arthritis drug (Vioxx) from the market, due to severe adverse effects observed in many of its users (Exhibit 1). As a result, Merck's share price fell \$11.48 (27%) in one day, translating to a market-cap loss of \$25.6 billion. On August 19, 2005, the day a Texas jury found Merck liable for the death of a Vioxx user, the company's market cap fell another \$5 billion. During this trial it became apparent that Merck had been profiting from Vioxx during the time it knew Vioxx had serious adverse effects.

Merck had obtained approval from the US Food and Drug Administration (FDA) for its drug Vioxx on May 20, 1999. By 2003 Vioxx was available in more than 80 countries and sales had soared to over \$2.5 billion per year. Concurrently, increasing evidence

Continued

[1] This case is based upon an assignment submitted by Rahbar Rahimpour, one of the author's Executive MBA students at the Rotman School of Management. Mr. Rahbar gave permission for this use.

Continued

(including data from Merck's own studies) suggested that those taking Vioxx were at an increased risk of cardiac arrest and stroke. Yet the drug remained on the market until September 2004.

The impact of the withdrawal on Merck's shareholders, management, patients, FDA and other stakeholders was dramatic. Public confidence and trust in Merck and other pharmaceutical companies were eroded. Currently, there are more than 9600 lawsuits from more than 18,200 plaintiffs pending against Merck. The company recently announced that it is setting $970 million aside to deal with these lawsuits, although some estimates are that Vioxx could cost Merck more than $20–$25 billion.

The FDA has been following the Vioxx case with interest, and has created a website page to provide information and updates at http://www.fda.gov/cder/drug/infopage/COX2/default.htm. Significant information is contained in the FDA's Public Health Advisory on Vioxx as its manufacturer voluntarily withdraws the product (FDA News (9/30/2004) that is reproduced below as Exhibit 1) and in the FDA Vioxx Questions and Answers (9/30/2004) webpage at http://www.fda.gov/cder/drug/infopage/vioxx/vioxxQA.htm. Two journal references are also provided.

Questions

1. Utilizing the information provided and available on from web sources, use the ethical decision making techniques discussed in the chapter to form an opinion about whether Merck's decisions regarding Vioxx were ethical? Show your analysis.
2. In order to protect the public more fully, what should the FDA do given the Vioxx lessons?

References

Comparison of upper gastrointestinal toxicity of rofecoxib and naproxen in patients with rheumatoid arthritis. VIGOR Study Group, *New England Journal of Medicine,* Nov 2000 23;343 (21):1520-8, 2 p following 1528.

Cardiovascular events associated with rofecoxib in a colorectal adenoma chemoprevention trial. *New England Journal of Medicine,* Mar 2005 17;352(11):1092-102. Epub 2005 Feb 15.

EXHIBIT 1 Letter from the FDA acknowledging Merck's voluntary withdrawal of Vioxx.

U.S. Food and Drug Administration

Department of Health and Human Services

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FDA News

FOR IMMEDIATE RELEASE
P04-95
September 30, 2004

Media Inquiries: 301-827-6242
Consumer Inquiries: 888-INFO-FDA

FDA Issues Public Health Advisory on Vioxx as its Manufacturer Voluntarily Withdraws the Product

The Food and Drug Administration (FDA) today acknowledged the voluntary withdrawal from the market of Vioxx (chemical name rofecoxib), a non-steroidal anti-inflammatory drug (NSAID) manufactured by Merck & Co. FDA today also issued a Public Health Advisory to inform patients of this action and to advise them to consult with a physician about alternative medications.

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Merck is withdrawing Vioxx from the market after the data safety monitoring board overseeing a long-term study of the drug recommended that the study be halted because of an increased risk of serious cardiovascular events, including heart attacks and strokes, among study patients taking Vioxx compared to patients receiving placebo. The study was being done in patients at risk of developing recurrent colon polyps.

"Merck did the right thing by promptly reporting these findings to FDA and voluntarily withdrawing the product from the market," said Acting FDA Commissioner Dr. Lester M. Crawford. "Although the risk that an individual patient would have a heart attack or stroke related to Vioxx is very small, the study that was halted suggests that, overall, patients taking the drug chronically face twice the risk of a heart attack compared to patients receiving a placebo."

Dr. Crawford added that FDA will closely monitor other drugs in this class for similar side effects. "All of the NSAID drugs have risks when taken chronically, especially of gastrointestinal bleeding, but also liver and kidney toxicity. They should only be used continuously under the supervision of a physician."

FDA approved Vioxx in 1999 for the reduction of pain and inflammation caused by osteoarthritis, as well as for acute pain in adults and for the treatment of menstrual pain. It was the second of a new kind of NSAID (Cox-2 selective) approved by FDA. Subsequently, FDA approved Vioxx to treat the signs and symptoms of rheumatoid arthritis in adults and children.

At the time that Vioxx and other Cox-2 selective NSAIDs were approved, it was hoped that they would have a lower risk of gastrointestinal ulcers and bleeding than other NSAIDs (such as ibuprofen and naproxen). Vioxx is the only NSAID demonstrated to have a lower rate of these side effects.

Merck contacted FDA on September 27, 2004, to request a meeting and to advise the agency that the long-term study of Vioxx in patients at increased risk of colon polyps had been halted. Merck and FDA officials met the next day, September 28, and during that meeting the company informed FDA of its decision to remove Vioxx from the market voluntarily.

In June 2000, Merck submitted to FDA a safety study called VIGOR (Vioxx Gastrointestinal Outcomes Research) that found an increased risk of serious cardiovascular events, including heart attacks and strokes, in patients taking Vioxx compared to patients taking naproxen. After reviewing the results of the VIGOR study and other available data from controlled clinical trials, FDA consulted with its Arthritis Advisory Committee in February 2001 regarding the clinical interpretation of this new safety information. In April 2002, FDA implemented labeling changes to reflect the findings from the VIGOR study. The labeling changes included information about the increase in risk of cardiovascular events, including heart attack and stroke.

Recently other studies in patients taking Vioxx have also suggested an increased risk of cardiovascular events. FDA was in the process of carefully reviewing these results, to determine whether further labeling changes were warranted, when Merck informed the agency of the results of the new trial and its decision to withdraw Vioxx from the market.

Additional information about this withdrawal of Vioxx, as well as questions and answers for patients, is available online at http://www.fda.gov/cder/drug/infopage/vioxx/default.htm.

ETHICS CASE Just Make the Numbers!

The discussion between Don Chambers, the CEO, and Ron Smith, the CFO, was getting heated. Sales and margins were below expectations, and the stock market analysts had been behaving like sharks when other companies' published quarterly or annual financial results failed to reach analysts' expectations. Executives of companies whose performance numbers failed to meet the levels projected by the executives or the analysts were being savaged. Finally, in frustration, Don exclaimed:

> *"We must make our quarterly numbers! Find a way, change some assumptions, capitalize some line expenses—just do it! You know things will turn around next year."*

And he stormed out of Ron's office.

Question

1. What should Ron consider when making his decision?

ETHICS CASE Smokers Are Good for the Economy—Really[1]

Antismoking advocates cheered in the summer of 1997 when the U.S. tobacco industry agreed to pay out more than US$368.5 billion to settle lawsuits brought by forty states seeking compensation for cigarette-related Medicaid costs. Mississippi Attorney General Mike Moore, who helped organize the states' legal campaign, called the pact "the most historic public health achievement in history." But were the states right to do what they did?

The fundamental premise of lawsuits, and other anti-tobacco initiatives, is that smokers—and, hence, tobacco companies—place an added tax on all of us by heaping extra costs onto public health care systems. The argument is that those, and other social costs, outweigh the billions in duty and tax revenue that our governments collect from cigarette distribution.

But a basic actuarial analysis of that premise suggests that quite the opposite is true. As ghoulish as it may sound, smokers save the rest of us money because they die sooner and consume far less in health care and in benefits such as pensions. The extra costs they do generate are far outweighed by the subsidies they pay each time they plunk down their money for a pack of cigarettes.

First of all, let's look at life expectancy consistently over the past decade. In 1994 testimony before the U.S. Senate Finance Committee, the U.S. Office of Technology Assessment showed that the average smoker dies fifteen years earlier than a nonsmoker, so smokers cost society less in health care bills than nonsmokers because they die about a decade earlier. The longer a person lives, the more it costs to treat him or her, especially since the vast majority of health care costs occur in the last few years of life.

One of the paradoxes of modern medicine is that advances in treatments that extend lives have actually increased lifetime health care costs. People who would have died from an acute illness during their working life in the past are now enjoying lengthy retirements, and suffering various debilitating diseases that require high-cost medical intervention. According to an expert, former Colorado governor Richard Lamm, who is now director of the Center for Public Policy and Contemporary Issues at the University of Denver, the average nonsmoker is treated for seven major illnesses during his or her lifetime. The average smoker survives only two major illnesses.

So how much more do nonsmokers add to the national health care bill than smokers? One of the

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[1] This case was taken substantially, with permission, from an article written by John Woolsey, a prominent actuary who has been involved in the study of the costs of health care. The article, "Society's Windfall Profit from Smokers," was published in the *Ottawa Citizen* on August 4, 1998.

Continued

best studies is by Duke University economist Kip Viscusi,[2] who conducted an exhaustive comparative analysis in 1994 for a conference on tax policy hosted by the National Bureau of Economic Research in Washington, DC.

Viscusi concluded that smokers, in essence, subsidize the health care costs of nonsmokers. Using government statistics, Viscusi calculated the medical costs of tobacco by adding up things like the percentage of patient days for lung cancer treatment in hospitals that can be attributed to smoking and burn injuries and deaths from fires started by mislaid cigarettes. Viscusi then took into account other costs—by dying younger, smokers deprive society of income tax. Viscusi even added a charge for costs related to second-hand smoke. Viscusi then calculated how much tobacco saves society. Because they receive considerably fewer payments from government and employer pension plans and other retirement benefits, and consume fewer drug benefits, nursing home and hospital dollars, he estimates that the average American smoker saves society on each pack of cigarettes sold in the United States, leaving a net surplus of 31 cents over the costs attributable to smoking (see 3 percent discount column, following page). Adding the 80 cents per package in taxes that American smokers pay brings the total surplus to $1.11 for every pack of smokes.

Other experts have argued that there is a loss of productivity to society because smokers take more sick days than nonsmokers. But is this cost borne by the economy as a whole, or by individual smokers whose absences mean that they will not reach their full earnings potential due to missed job promotions and merit pay? The bottom line in all this is that an actuarial approach shows that the facts do not support current political claims about the cost of smoking. Smokers actually leave the economy better off and should be encouraged, not discouraged through taxes, restrictions, and lawsuits.

[2] Viscusi, W. Kip. "Cigarette Taxation and the Social Consequences of Smoking." *Tax Policy and the Economy,* (1995): 51–101.

Questions

1. What can an ethical analysis add to Viscusi's actuarial analysis?
2. Would an ethical analysis change the conclusion reached? Why?

External Insurance Costs Per Pack of Cigarettes

	1993 COST ESTIMATE DISCOUNT RATE			1993 COST ESTIMATE WITH TAR ADJUSTMENT DISCOUNT RATE		
	0%	3%	5%	0%	3%	5%
Costs						
Medical care <65	0.288	0.326	0.357	0.330	0.373	0.410
Medical care ≥65	0.375	0.172	0.093	0.384	0.177	0.096
Total medical care	0.663	0.498	0.451	0.715	0.550	0.505
Sick leave	0.003	0.012	0.019	0.000	0.013	0.020
Group life insurance	0.222	0.126	0.084	0.241	0.136	0.091
Nursing home care	−0.584	−0.221	−0.074	−0.599	−0.226	−0.076
Retirement pension	−2.660	−1.099	−0.337	−2.886	−1.193	−0.365
Fires	0.014	0.016	0.018	0.014	0.016	0.018
Taxes on earnings	0.771	0.351	0.107	0.883	0.402	0.122
Total net costs	−1.571	−0.317	0.268	−1.633	−0.302	0.315

Source: Viscusi, W. Kip. "Cigarette Taxation and the Social Consequences of Smoking," *Tax Policy and the Economy,* National Bureau of Economic Research (1995): 74.

ETHICS CASE Ford Pinto*

In order to meet strong competition from Volkswagen as well as other foreign domestic subcompacts, Lee Iacocca, then president of Ford Motor Co., decided to introduce a new vehicle by 1970, to be known as the Pinto. The overall objective was to produce a car at or below 2,000 pounds with a price tag of $2,000 or less. Although preproduction design and testing normally requires about three-and-a-half years and the arrangement of actual production somewhat longer, design was started in 1968 and production commenced in 1970.

The Pinto project was overseen by Robert Alexander, vice president of car engineering, and was approved by Ford's Product Planning Committee, consisting of Iacocca, Alexander, and Ford's group vice president of car engineering, Harold MacDonald. The engineers throughout Ford who worked on the project "signed off" to their immediate supervisors, who did likewise in turn to their superiors, and so on to Alexander and MacDonald and, finally, Iacocca.

Many reports were passed up the chain of command during the design and approval process, including several outlining the results of crash tests, and a proposal to remedy the tendency for the car to burst into flames when rear-ended at 21 miles per hour. This tendency was caused by the placement of the car's gas tank between the rear axle and the rear bumper such that a rear-end collision was likely to drive the gas tank forward to rupture on a flange and bolts on a rear axle housing for the differential. The ruptured tank would then spew gas into the passenger compartment to be ignited immediately by sparks or a hot exhaust.

FATALITY PAYMENT COMPONENT	1971 COSTS
Future productivity Losses	
Direct	$132,000
Indirect	41,300
Medical costs	
Hospital	700
Other	425
Property damage	1,500
Insurance Administration	4,700
Legal and court	3,000
Employer losses	1,000
Victim's pain and suffering	10,000
Funeral	900
Assets (lost consumption)	5,000
Miscellaneous	200
Total per fatality:	$200,725

Ford's Cost–Benefit Analysis

Benefits: SAVINGS	UNIT COST	TOTAL
180 burn deaths	$200,000	$36,000,000
180 serious burn injuries	67,000	12,060,000
2,100 burned vehicles	700	1,470,000
Total benefits		$49,530,000
Costs: **NUMBER OF UNITS**		
11 million cars	11	$121,000,000
1.5 million light trucks	11	16,500,000
Total costs		$137,500,000

The remedies available to Ford included mounting the gas tank above the rear axle, which would cut down on trunk space, or installing a rubber bladder in the gas tank. Ford experimented with the installation of rubber bladders but apparently decided they were

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*More comprehensive cases on the Pinto problem can be found in Donaldson, T., & Gin, A. R. *Case Studies in Business Ethics*. Englewood Cliffs, NJ: Prentice-Hall, 1990, pp. 174–83 (original case by W. M. Hoffman); and Valasquez, M. G. *Business Ethics: Concepts and Cases*. Englewood Cliffs, NJ: Prentice-Hall, 1988, pp. 119–23.

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not cost-effective. Later, as part of a successful lobby effort against government regulations for mandatory crash tests (crash tests were delayed eight years, until 1977), Ford's cost–benefit analysis came to light in a company study entitled "Fatalities Associated with Crash-Induced Fuel Leakage and Fires." As the details previously outlined show, the costs of installing the rubber bladder vastly exceeded the benefits.

Ford took the $200,000 figure for the cost of a death from a study of the National Highway Traffic Safety Administration, which used the estimates in the table on the previous page.

Questions

1. Was the decision not to install the rubber bladder appropriate? Use the 5-question framework to support your analysis.
2. What faults can you identify in Ford's cost–benefit analysis?
3. Should Ford have given its Pinto customers the option to have the rubber bladder installed during production for, say, $20?

ETHICS CASE The Kardell Paper Co.

Background

The Kardell paper mill was established at the turn of the century on the Cherokee River in southeastern Ontario by the Kardell family. By 1985, the Kardell Paper Co. had outgrown its original mill and had encompassed several facilities in different locations, generating total revenues of $1.7 billion per year. The original mill continued to function and was the firm's largest profit center. The Kardell family no longer owned shares in the firm, which had become a publicly traded company whose shares were widely held.

Kardell Paper Co. was a firm with a record of reporting good profits and had a policy of paying generous bonuses to the chief executive officer and other senior executives.

Kardell's original mill was located near Riverside, a community of 22,000. Riverside was largely dependent on the mill, which employed 500 people. The plant, while somewhat outdated, was still reasonably efficient and profitable. It was not designed with environmental protection in mind, and the waste water that discharged into the Cherokee River was screened only to remove the level of contaminants required by provincial regulation. There were other industrial plants upstream from the Kardell plant.

The residential community of Riverside, five miles downstream from the plant, was home to many of the Kardell plant's management, including Jack Green, a young engineer with two children, ages one and four.

Jack, who was assistant production manager at the Kardell plant, was sensitive to environmental issues and made a point of keeping up on the latest paper mill technology. Jack monitored activity at the plant's laboratory, which in 1985 employed a summer student to conduct tests on water quality in the Cherokee River immediately downstream from the plant.

These tests were taken across the entire width of the river. The tests conducted nearest the plant's discharge pipe showed high readings of an industrial chemical called sonox. Farther away from the plant, and on the opposite shore of the river, the water showed only small trace amounts of sonox. Sonox was used in the manufacture of a line of bleached kraft paper that Kardell had begun to make at its plant in recent years.

The Issue

The student researcher discovered that the plant lab was not including the high readings of sonox in its monthly reports to management, so the student showed the complete records to Jack. In the summer of 1985, Jack made a report to the CEO with a recommendation that in-depth studies be conducted into the situation and its implications for public health and long-term effects on the ecology.

In recommending that Kardell carry out an "environmental audit" of its operations, Jack pointed out that local doctors in Riverside had been expressing concern over what appeared to be an unusually high

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rate of miscarriages and respiratory disorders in the community. Jack told the CEO there were data suggesting a possible link between health problems and sonox, but no definite proof. Medical research into sonox's possible effects on humans was continuing.

In bringing his concerns to the CEO's attention, Jack offered as a possible solution the option of Kardell adopting a new processing technology which used recycling techniques for waste water. This technology, already employed by a handful of plants in Europe, enabled a plant to operate in a "closed cycle" that not only protected the environment but reclaimed waste material, which was then sold to chemical producers. Thus, in the long term the new process was cost-effective. In the short run, however, refitting the existing Kardell plant to incorporate the new technology would cost about $70 million, and, during the retrofit, the plant would have to operate at reduced capacity levels for about a year and possibly be closed down altogether for an additional year to make the change-over.

The Response

Kardell's traditional response to environmental concerns was reactive. The company took its cues from the regulatory climate. That is, the provincial environment ministry would apply control orders on the plant as new limits on emissions of various compounds came into effect, and Kardell would then comply with these orders.

In raising his concerns in 1985, Jack pointed out that the Ministry of Environment, responding to the serious nature of concerns raised by the sonox issue, was considering internal proposals from its staff that additional research be done into the sources and implications of sonox. Given the early stage of work in this area, Jack could offer no indication of when, if ever, the Ministry would enact new regulations to do with sonox. He argued, however, that the ground rules might change, as they had with previous compounds, and that Kardell should give some thought to the worst-case scenario of how the sonox issue could turn out down the road.

Kardell's CEO was sympathetic to the concerns raised by Jack, a valued employee of the company who had proved himself in the past by identifying many cost-efficiency measures. The CEO felt obliged, however, to match Jack's concerns about sonox against the substantial cost of refitting the plant. The CEO felt there simply was not enough data upon which to base such an important decision, and he was wary of any external force that attempted to influence the company's affairs. The CEO told Jack, "We simply can't let these 'greens' tell us how to run our business."

While the CEO did not feel it would be appropriate for Kardell to adopt the recommendations in Jack's report, the CEO did take the step of presenting the report to the board of directors, for discussion in the fall of 1985.

Kardell's board of directors represented a cross-section of interest groups. Everyone on the board felt a responsibility toward the shareholders, but, in addition, some members of the board also paid special attention to community and labor concerns. The board was composed of the CEO and president of the firm, along with several "outside" directors: two local businesspeople from Riverside, a representative of the paperworkers' union at the plant, a mutual fund manager whose firm held a large block of Kardell shares on behalf of the fund's investors, an economist, a Riverside city councillor, and the corporation's legal counsel.

Each member of the board spoke to Jack's report from his or her perspective. The Riverside representatives—the city councillor and the two businesspeople—wanted assurances that the community was not in any danger. But they also said, in the absence of any firm proof of danger, that they were satisfied Kardell probably was not a source of harmful emissions.

The lawyer pointed out that legally Kardell was in the clear: it was properly observing all existing regulations on emission levels; in any case, there was no clear indication that the Kardell mill was the only source of sonox emissions into the Cherokee River. While acknowledging the health concerns that had recently arisen over sonox, the lawyer thought it prudent to wait for the government to establish an acceptable limit for sonox emissions. Besides, the lawyer added, while liability actions had been initiated against two or three other mills producing sonox, these claims had been denied through successful defense actions in court on the grounds of lack of clear evidence of a significant health hazard.

The labor representative expressed concern about any compound that might affect the health of Kardell employees living in the area. But the labor official also had to think about the short-term consideration of job loss at the plant and the fact that, with the plant shut down, there were few other employment opportunities in the area to fill the gap. The board representatives from Riverside pointed out that, obviously, the local economy would be severely affected by the shutdown to refit the plant. And the mutual fund manager agreed with the CEO that, at least in the short term, Kardell's profitability and

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share price would suffer from a decision to undertake a costly overhaul of the facility.

The Decision

After much debate, the board decided to defer consideration of Jack's proposals pending the results of government research into this issue. It also asked Jack to continue monitoring the regulatory climate so that the plant would always be in basic compliance with provincial emission standards.

During the next two years, Jack presented similar warnings to the board regarding sonox and continued to meet with the same response. As a precautionary measure, he kept copies of his reports in his own files so there could never be any question of the timing or substance of his warnings to the board. During this same period, an above-average incidence of miscarriages, birth defects, and respiratory ailments was reported in the Riverside area.

Questions

1. Who are the stakeholders involved, and what are their interests?
2. Which stakeholders and interests are the most important? Why?
3. What was wrong with the quality of the board of directors' debate?
4. What is the downside if the right decision is not made—consider economic factors and also what Jack might do?

The Kardell case was prepared by David Olive, Graham H. Tucker, Tim J. Leech, and David Sparling.

Source: *Agenda for Action Conference Proceedings,* the Canadian Center for Ethics & Corporate Policy, 1990, pp. 20–21.

READINGS

Cost–Benefit Analysis

Leonard J. Brooks, Jr., CA

CAmagazine, October 1979

Corporate management has become increasingly aware that business decisions often have an impact that cannot be easily measured by traditional accounting analysis. Governments and special interest groups have been quick to point out that many costs resulting from business decisions are not reflected in (or are external to) corporate accounts. Pollution damage costs, for instance, must be borne by neighbors, not by the companies causing the problems. Understandably, then, corporate executives are searching for analytical techniques that will take account of such external costs and benefits when they are deliberating company policy, resource allocation (to pollution controls, for example), desirability of potentially harmful projects and other programs that will have an impact on the general public. Inevitably, they are looking to their accountants to develop the required cost–benefit analyses to supplement usual rate of return projections.

There are many reasons why management will continue to voluntarily ask for and use cost–benefit analyses. The best managers usually try to reduce uncertainty in their decision making as much as possible, and knowing in advance the costs and benefits of an action could forestall inciting an unpleasant reaction by an angry populance. Furthermore, data developed using cost–benefit techniques can serve as an excellent predictor of cash costs that will show up later in the traditional accounts. Also, the social choices governing the implementation of government programs and regulations are often based on cost–benefit analyses. It may even be that organizations,

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both profit and non-profit, will someday be forced to justify their social existence in terms of cost–benefit analyses. Already, about 90% of the *Fortune 500* companies make social responsibility disclosures in their annual reports.[1]

TABLE 1 Uses of Cost–Benefit Analysis

PRIVATE SECTOR ORGANIZATIONS

- Support for government subsidy; grant or tariff.
- Estimate of impact of pollution on society.
- Valuation of employee time spent on public activities.
- Evaluation and allocation of resources to public projects or causes.
- Monitor mechanism for net corporate social contribution to society for the year and to date.
- Individuals.
- Support for damage claims arising from loss of life, eyes, limbs, etc.
- Valuation of leisure time.

PUBLIC SECTOR ORGANIZATIONS

Evaluation of social program alternatives leading to allocation of resources for:

- Health programs.
- Education programs.
- Recreation facilities.
- Conservation projects (flood control dams, reservoirs).
- Transportation improvement projects (airports, subways, tunnels, etc.).
- Formulation of regulations for pollution control.

There are already many indications that the use of cost–benefit analysis may become mandatory. For example, governments are about to require summaries of social costs and benefits before allowing new chemical plants to be built. A growing number of public-spirited shareholders are demanding increased disclosure of corporate contributions to society. An increasingly burdened electorate is challenging government largesse and is insisting on documented justification of new or further spending programs. Thus, in view of such pressures, accountants would be well-advised to become more familiar with the techniques and potential problems of cost–benefit analysis.

Cost–benefit analysis (CBA) can be used to (a) determine whether projects should be undertaken, and (b) to monitor the performance of a company or project. Table 1 provides a partial list of the areas where CBA is now being used in both the private and public sectors of our economy. The format for presentation of these impacts, their scope and other factors will be discussed later; first, it is useful to see how CBA differs from traditional accounting analyses in terms of scope and focus.

Shortfalls of Traditional Accounting Data

In comparison with cost–benefit analysis, traditional accounting analysis falls short on four counts:

1. It focuses on past actions, which are not as relevant as future actions for decision making.
2. It does not take into account external factors.
3. It considers some resources to be free, or to have no cost.
4. Its focus is far more narrow, relating almost always to shareholders' interests, rather than stakeholders' (or society's) interests.

The first shortfall, decision-time orientation, will not be news to most readers. The classic cartoon portraying the manager as an airline pilot flying a plane while looking backwards epitomizes the situation of decision makers using only historical financial reports in their deliberations. Fortunately, CBA looks ahead at what might happen so that decisions can be tempered by foresight.

Not taking external factors into account, the second shortfall, is more serious. In the case of pollution, the cost of clean-up or health damage is rarely shown in the accounts of the corporation responsible, since it is not borne by the company but by someone else. Yet such costs are undeniably real, and to omit them from the net profit figure significantly weakens it as a measure of the polluter's "contribution to society." To be fair, we should point out that the reverse (i.e., costs borne by a company and benefits reaped by society; company-funded scholarships, for example) also exists and should be taken into a corporation's analysis of costs and benefits.

The third type of shortfall noted in traditional accounting analysis is the consideration of many

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[1] *Social Responsibility Disclosure: 1977 Survey of Fortune 500 Annual Reports* (Cleveland: Ernst & Ernst, 1977).

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resources as being free. This usually occurs where no market mechanism exists to exact payment for resource use. Air and water are the most ready examples of "free" resources, but governments are already moving to regulate their use to protect the interests of other members of society, both present and future. Consequently, capital investment decisions should from now on reflect the potential costs of air and water regulation.

The fourth shortfall, the narrow focus of accounting analysis, is a result of the traditional desire to reflect the impact of corporate actions on the interest of shareholders. But corporations affect, and are responsible to, many other groups in society as well, and these are becoming more vocal in corporate affairs. These groups (employees, neighbors, customers, suppliers, bankers, etc.) are usually referred to as stakeholders, and stakeholder interest has been the focus of a number of recently developed accounting systems.[2]

Currently, however, there is considerable debate over the scope of these new hybrid accounting systems. In 1972, Linowes proposed that a "net social corporate contribution to society" be calculated; curiously, however, he limited the calculations to voluntary expenditures, and did not include, for example, costs involuntarily incurred to comply with government regulations.[3] Abt in 1977, proposed that the cost–benefit analysis leading to the determination of corporate net social equity include both voluntary and involuntary expenditures and be integrated into traditional financial statements.[4] The AICPA agreed that an integrated system would be ideal but, because of costs and the fact that CBA is still in an early stage of development, it has opted for a less sophisticated approach focusing on the organization's impact on, in turn: the environment, human resources, suppliers, etc.[5]

Indeed, although others have suggested even more complex approaches to organizational worth,[6] the long-term answer probably lies in a modification of the Abt Associates, Inc. traditional accounting model plus cost–benefit analysis.[7] But, as the AICPA found, the cost for a moderately large company to set up a system of accounts to duplicate the Abt model, before costing the data assembly each year, could be as much as $300,000—a price too high for most industries to contemplate at this time.[8] In addition, reports generated by this system will be of questionable value until industry standards of comparison are available and the knowledgeability of traditional financial report readers has been improved. Finally, time is required to thoroughly determine the interrelationships of the various comprehensive models.

Obviously, then, costs and other practical considerations will probably mean that the incorporation into financial reports of the disclosure of significant corporate impacts on society will happen gradually, taking into account one area at a time. Yet there should be no illusion that this type of one-dimensional analysis is all that is needed. As a part measure, however, it will make information available to relevant stakeholder groups and allow governments to provide, for instance, pollution standards by which corporate performance can be measured. And, regardless of whether CBAs are used to facilitate decisions or to monitor corporate performance, the basic techniques should be understood.

Techniques of Cost–Benefit Analysis

Instead of the normal captions "revenue," "expense" and "net profit," CBA terminology would be "benefits," "costs" and "excess of benefits over costs." The CBA concepts of benefits and costs are broader than revenues and expenses, because they take into account future and hitherto external values. Projects should be undertaken if benefits exceed costs or the benefits/cost ratio is greater than one. Usually, the larger the benefit/cost ratio, the more attractive the project; but occasionally, if a company has only limited funds to invest, small projects that are attractive from a benefit point of view must be bypassed in favor of larger projects that produce higher absolute levels of benefit. In other words, if only part of the resources available to be invested will be absorbed by the project(s) with the highest benefit/cost ratio, it is preferable to choose a project with a slightly lower benefit/cost ratio which uses more of the resource base and contributes overall benefits.

To illustrate, an unsophisticated yet typical CBA is set out in Table 2. The values used are hypothetical but readily attainable by means we'll discuss later.

[2] R. Estes, *Corporate Social Accounting* (New York, NY: John Wiley & Sons, 1976).

[3] D. Linowes, "An Approach to Socio-Economic Accounting, *The Conference Board Record*, Vol. IX, No. 11 (November 1972).

[4] C. C. Abt, *The Social Audit for Management* (New York: AMACOM, 1977).

[5] Committee on Social Measurement, *The Measurement of Corporate Social Performance* (New York: The American Institute of Certified Public Accountants, 1977).

[6] In L. J. Brooks, *Canadian Corporate Social Performance* (Hamilton, Ontario, Canada: The Society of Management Accountants of Canada), 1986, Chapter 3.

[7] Abt. *Op. cit.*

[8] *Ibid.* pp. 112–113.

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TABLE 2 JM Co. Ltd. Cost–Benefit Analysis of Social Impact Proposals: March 1979

	POLLUTION CONTROL EQUIPMENT PROTECTING WORKERS IN PLANT	UNIVERSITY ADMISSION SCHOLARSHIPS
Benefits (Present Valued at 10%)		
Reduction in worker health costs borne by society	$500,000	
Increase in worker productivity	200,000	
Improvements in level of earnings of scholarship recipients		$600,000
	700,000	600,000
Costs (Present Valued at 10%)		
Pollution equipment	350,000	
Scholarships paid		400,000
	$350,000	$200,000
Benefit/cost ratio	2/1	3/2
Decision		
(1) if only one project can be funded	X	
(2) if all projects with a positive benefit/cost/ratio can be funded	X	X
Time horizon: 10 years from March 1979		

While there may be some difference of opinion over the validity of considering increased earnings of scholarship recipients as the "benefit" of these payments, such a measure is, on balance, conservative and facilitates a numeric comparison with the project costs and thus results in a more informed decision.

The general framework for CBA is identical to the discounted cash flow approach used in capital budgeting analysis. For example, the present value of net costs or net benefits may be derived from the sum of the future values discounted at an appropriate discount rate, or

present value of net costs or net benefit

$$= \frac{B_1 - C_1}{(1+r)^1} + \frac{B_2 - C_2}{(1+r)^2} + \frac{B_3 - C_3}{(1+r)^3} + \ldots\ldots\infty$$

$$= \sum_{n=1}^{\infty} \frac{B_n - C_n}{(1+r)^n}$$

where:

B is the benefit for the year, accruing at the end of the year.

C is the cost for the year.

r is the discount rate per annum reflecting the opportunity cost for capital invested in projects of comparable risk.

1, 2, 3, . . . n specifies the period/year with n the final period.

The Discount Rate

Monies used to finance projects are necessarily withheld from other uses such as private investment or personal consumption. Therefore, the cost of such financing is properly measured by computing the cost of the opportunity foregone, whether that is the lost after-tax marginal rate of return on other investments or the price consumers would be willing to pay not to forego deferring their consumption. Since such alternative costs are not practically available, the results of CBA studies are usually discounted at a weighted average marginal rate based on the projected sources of financing to be employed. The weighted average marginal cost of capital approach has prevailed in practice even though economists have noted that, in some instances, the use of a single discount rate may not produce valid integrations of present and future consumption foregone.[9]

[9] M. S. Feldstein, "The Inadequacy of Weighted Discount Rates," in *Cost–Benefit Analysis*, ed. R. Layard (Harmondsworth, Middlesex, U.K.: Penguin Books, Ltd., 1973), pp. 311–322.

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In the case of a corporation, the discount rate is usually its average weighted after-tax cost of capital, plus a risk factor depending on the nature of the project's cash flows, less whatever the amount with which the company wishes to subsidize projects with heavy social orientation. A similar approach should be followed for non-profit organizations. For government agencies, however, it has been argued that their size and taxing mandate produces a relatively risk-free cost of capital which, if they used it, would be lower than the cost to firms in the private sector. Over time, the use of the lower governmental rate would result in an increasingly larger rate of investment by the public sector in comparison with that of the private, and the balance of activity would shift further towards the former. To counteract this tendency, the governments of Canada and Britain use a 10% discount rate on most projects.[10]

Measurement of Costs and Benefits

Although there are problems in choosing the appropriate discount rate, they are minor in comparison with the difficulties of identifying and measuring the annual future costs and benefits themselves.

Whenever possible, direct measurement is preferable. For example, when assessing the costs resulting from air pollution caused by a generating station, we can measure the saving (benefit) from the use of coal or natural gas instead of oil. The costs could also be partially measured by a direct survey estimate of the increase in local health costs attributable to respiratory problems and to the increased house maintenance costs due to smoke damage.[11]

Unfortunately, many costs and benefits cannot be determined directly, and surrogate or indirect means must be used to estimate the values involved, although, admittedly, it is virtually impossible to capture all of the relevant characteristics in the surrogate value. For instance, and continuing our pollution example, it is impossible to measure directly the aesthetic values that will be lost in the cloud of smoke and smell that will enfold the community if coal is used as a fuel. An indirect or surrogate value could be estimated for this aesthetic loss, however, by surveying the local residents to see how much they would be willing to pay to have the problem improved or removed. From this survey a type of demand curve for smoke and smell abatement could be fashioned and aesthetic values estimated.[12] The cost of a pollution control project could then be compared with the curve to see if the overall demand is large enough to justify going ahead.

Another approach to determining the cost of pollution is to calculate the full cost of health damage incurred based on the value of the time lost by patients while ill. For patients who would not have been working for wages if well, the appropriate approach would be to identify the most lucrative opportunity lost by being ill; and, once this is done, the value loss, or opportunity cost, can be estimated by (for instance) estimating the cost of task delay or of paying someone else to complete the task. If a patient loses wages while ill, then this would be one measure of the opportunity cost of time lost.

A further example of surrogate measurement is the evaluation of the net benefit derived from a company-sponsored training program (total cost $60,000) for 50 personnel. Unable to measure the benefit directly, we make the assumption that the benefit will be reflected by increased earnings (say $5,000 per annum) over the expected 20-year average working life of each employee. Hence the net benefit of the courses would be $2,068,500 (calculated as 50 × $5,000 a_{20} 10% [i.e., a 20-year annuity at 10% rate of discount: less $60,000)] before tax.

Additional CBA approaches are outlined in Table 3.[13]

TABLE 3 Different Methods of Evaluating the Benefits of a Recreation Facility

Calculation of:
1. Gross expenditure by users on travel, equipment, etc.;
2. Market value of fish caught (production or output value);
3. Production cost of project (input value);
4. Market value of recreation services produced × number of users.

Survey of:
1. Users' willingness to pay for use;
2. Users' (and other interested parties') willingness to pay to prevent deprival of use or enjoyment.

[10] D. B. Brooks, *Conservation of Minerals and of the Environment* (Ottawa: Canada Department of Energy Mines and Resources, 1974).

[11] M. O. Alexander and J. L. Livingstone, "What Are the Real Costs and Benefits of Producing "Clean Electric Power?" *Public Utilities Fortnightly* (August 30, 1973).

[12] Estes, *Op. cit.*, pp. 111–114.

[13] J. L. Knetsch and R. K. Davis, "Comparisons of Method for Recreation Evaluation," in *Water Research*, ed. A. V. Kneese and S. C. Smith (Baltimore: The John Hopkins Press for Resources for the Future, Inc., 1966).

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Shortcomings of Cost–Benefit Analysis

Some accountants will argue that CBA is too subjective and too removed from their traditional pursuits to be worth studying. But this argument overlooks:

- The longevity of CBA, which has been used since before 1844.[14]
- The prominence of CBA in governmental decision making.
- The apparent likelihood that CBA techniques will be employed in the private sector to provide a focus for decisions on corporate programs that will have an impact on society.

Accountants have traditionally assumed a central role in providing data for decisions in the private sector and, if this position is to be maintained, it is in the accountant's best interest to be familiar with CBA techniques and their shortcomings. Furthermore, since accountants are often directly involved with (or indirectly subject to) CBA decisions in the public sector, they will be unable to make decisions properly, to advise less-skilled decision makers, or to challenge specific CBA proposals effectively, unless they are aware of the relevant CBA techniques and their shortcomings. The reasoning behind our stressing the importance of informed advice will become more apparent when the variety and seriousness of CBA shortcomings are understood. The shortcomings can be grouped into three categories:

- Choices available to the preparer.
- Constraints to be considered by the preparer and user.
- Issues not resolvable by CBA.

The Choices Available

The choices are many and, if too inaccurate, would bias a CBA to the point where unwise decisions would result. There are methods by which bias and unreasonableness can be mitigated, but first the decision maker must understand the potential problems.

When beginning a CBA, the preparer must make certain assumptions such as the rate of discount (r%) and the time horizon over which costs and benefits will be taken into account. Obviously, the choice of a long time horizon might favor some projects, even though the uncertainties of estimation are too great to warrant the inclusion of costs and benefits to be incurred 20–25 years from now. If too high a discount rate is chosen, distant costs and benefits will have less impact on the CBA than they should and, even if no longer-term costs and benefits exist, decision makers might reject proposals when their existing opportunities for investment are far less than r%.

Since it is essential that an accurate opportunity cost be estimated for the monies to be used to finance each CBA project, is the 10% test rate used by Canadian and British governments appropriate? For instance, if 10% is too low, there will be a tendency for the public sector to accept more projects than the private sector would. On the other hand, since private sector capital budgeting decisions do not incorporate all the costs or external factors that public sector CBAs do (thereby inflating projected rates of return), maybe the 10% test rate is acceptable. Surely accountants should have a thorough understanding of this fundamental issue.

Which costs and benefits to include or exclude is another basic choice to be made, one that reflects the special interests of the group making the CBA decision. If the decision makers are an upstream town council, they may be unwilling to include in their analysis the cost incurred by a downstream town to clean up pollution put into the river by the upstream municipality. If, in the same situation, all filtration costs were borne by the province (a larger political jurisdiction to which both towns belong), then the costs of clean-up would be recognized. In other words, decision makers can be led astray if the boundaries of the CBA analysis are not broad enough.

Bias can enter CBA through unfortunate choices of surrogates and of the methods used to assess people's values. Surrogates are rarely mirror images of what one is attempting to measure. Table 3 indicates a wide range of alternatives available to evaluate a park or other recreation facility. Some alternatives listed are more conservative than others, so decision makers should examine surrogates closely to avoid being misled. It should also be kept in mind that the surrogates chosen will most often focus on output or production values, rather than on consumption values. For instance, when evaluating the time of an unemployed person, the conventional CBA approach focusses on his or her production opportunity loss (nil since he/she is unemployed) and he is not asked how much his inactivity or leisure is worth.

Having listed some of the pitfalls, it is comforting to note that a wary review, looking for each item mentioned, can be aided greatly by sensitivity analysis. The discount rate, the time horizon and the choice of surrogate can be varied to see if the CBA outcome changes and in what way. Since CBA is a technique used most frequently to rank several possible projects, it is not essential that a project be valued exactly, but rather that it may be ranked better or worse than other alternatives.

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[14] J. Dupuit, "On the Measurement of Utility of Public Works" (translated from the French published in 1844). *International Economic Papers*, Vol. 2 (London: Macmillan & Co. Ltd.), 1952.

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Constraints

With respect to the constraints that must be considered by CBA preparers and users, it is imperative that projects be mutually exclusive; or, if a joint project is under consideration, that the CBA analysis include all aspects of the project. Furthermore, accepted projects must meet legal requirements and be amenable to administration. Occasionally, budgetary constraints are removed and decision makers are told to spend their predetermined budget without regard to the opportunity cost (r%) of the money spent. In this case, however, only analyses using an appropriate discount rate will ultimately be defensible.

Unresolvable Issues

The CBA decision maker must realize that many issues can never be fully resolved by CBA techniques. CBA doesn't take into account issues of equity, such as the advisability of penalizing one group to the advantage of another. Moral issues are likewise excluded or abstractly incorporated. For instance, the $600,000 spent earlier on scholarships might feed 50,000 children in southeast Asia. Similarly, the loss of an eye, limb or human life is valued by the discounted earnings stream foregone, whereas, fortunately, society is willing to pay large amounts to maintain the lives of leukemia victims and provide dialysis equipment for kidney patients whose future incomes may be nil. Even value judgments on issues of less importance than human life may not be handled to everyone's satisfaction. Beauty is in the eye of each beholder and to impute an aesthetic judgment for a whole group based on the average of several individual opinions may not provide an accurate picture. On the other hand, decision makers' judgments often depend on external factors and are therefore enhanced by quantitative CBA analysis, however rough and imperfect.

CBA Is Here to Stay

Society in general, public organizations, private corporations and individuals are increasingly looking beyond traditional accounting analysis for broader impact measurements. Traditional accounting will remain valuable, but, in advanced societies, organizations must be aware and take account of their external impacts as well. Governments are already making social choices for all of us based on cost–benefit analysis. Accountants, therefore, would be well advised to increase their understanding of cost–benefit analysis and its pitfalls, or else lose their place at the right hand of decision makers.

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READINGS

Ethical Analysis for Environmental Problem Solving

Graham Tucker

Canadian Centre for Ethics & Corporate Policy, 1990

Introduction

Today, no company can claim to be "ethical" unless it is demonstrating a concern for the environment. The focus of this conference is on the tools of ethical analysis and problem solving that can provide a practical framework for action.

Before finalizing a business decision, an executive should ask a series of questions designed to ensure the best possible choice is made both for the shareholders as well as other stakeholders. These questions ought to be asked in the following order to

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canvass the values shown:

1. Is it profitable? (market values)
2. Is it legal? (legal values)
3. Is it fair? (social values)
4. Is it right? (personal values)
5. Is it sustainable development? (environmental values)

These questions have been built into the "five-box" framework for ethical analysis which is shown in Figure 1.

FIGURE 1 A Framework for Ethical Analysis—Changing Ground Rules and a Sustainable Future

Figure 1 Questions

The focus on values is critical to the proper analysis of business decisions because morality, which is becoming more and more critical to the health of corporations and society, cannot be legislated. It depends on the value system of corporate leaders and employees. Moreover, the tough choices required among alternatives often defy quantification and must be based on the values of the decision-maker.

Nowadays, it is not safe to judge a prospective action just on its contribution to profits, because the action may not be legal. Even if it is profitable and legal, society will penalize the company if the action is not also perceived to be fair and right. Recently, as the fragility of our global environment has become clear, society has begun to demand that corporate actions fit into the sustainable development of our economy.

The application of the "five-box" framework for analysis will be developed in the analysis of the Kardell Paper Co. case, after a discussion of some terms used in ethical analysis and the outlining of a framework for ethical problem solving.

Some Important Distinctions

It's important that we make important distinctions (a) between management and leadership and (b) between being legal and being ethical. Lack of clear distinction in these areas causes a lot of confused thinking in business ethics.

When managers are successful, usually it is because they are high-energy, hard-driving individuals who know how to play by the rules of the game. They efficiently and single-mindedly strive to achieve the goals of the organization. But they may or may not be leaders.

Robert Greenleaf, author of the book *Servant Leadership*, defines leaders as "those who better see the path ahead and are prepared to take the risks and show the way." The characteristic which sets leaders apart from managers is their intuitive insight and the foresight which enables them to go out ahead and show the way. Why would anyone accept the leadership of another, except that the other sees more clearly where it's best to go? The manager, by contrast, tends to be part of the bureaucracy that wants to preserve the status quo. The managerial role determines the values. Managers do what's expected of them. That role often overrides the managers' personal values.

Role responsibility can be very powerful. The management of Johns-Manville knew for years that its product asbestos was linked by scientists to lung cancer in its employees. Similar situations existed with the Ford Pinto and the Dalkon Shield.

Managers often feel powerless to act outside of their prescribed role; they feel that they don't have the authority to buck the system. The corporate authority may be sanctioning the unethical behavior. It takes the moral authority of a leader to change the system, and this is often notably lacking in both politics and business.

Robert Greenleaf points out that the failure of businesspeople to use foresight and take creative action before a crisis arises is tantamount to *ethical failure*, because managers in these cases lack courage to act when there is still some freedom to change course. Many managers opt for short-term profit at the expense of long-term viability. On that basis there are probably a lot of people walking around with an air of innocence which they would not have if society were able to pin the label "unethical" on them for

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their failure to foresee crises and to act constructively when there was freedom to act.

Similarly, it is important that we distinguish between being legal and being ethical. The law is frequently quite distinct from morality. It is mainly concerned with the minimum regulation required for public order, whereas ethics attempts to achieve what is "best" for both the individual and society. Thus it's possible to be operating within the law and yet be unethical. The legal limits for a certain pollutant may have been established before it was discovered to be unsafe at that level. The company may be operating legally. Yet by knowingly endangering the health of workers or the community, the company is acting in an unethical manner.

Many corporate codes of ethics express a commitment to keeping the letter of the law, but that may not protect them from censure when the new data becomes public knowledge. Obviously we have to have laws and regulations to avoid the chaos of a lawless society. However, the ethical crunch that is being experienced by the business world today is that the communications revolution is putting more information in the hands of the public. It used to be possible to exercise power and control by withholding or concealing information. If you don't know that asbestos dust is giving you lung cancer you can't do anything about it. The public now finds out very quickly what is going on, and it is demanding ethical conduct because this affects its well-being.

We have recently witnessed dramatic changes in Eastern Europe, as shared information has empowered previously powerless people to rise up and take control of their own destiny in seeking a better life. Precisely the same power is at work in our society, changing the rules of the game for business. Five years ago, the concern for the environment ranked sixth in the value system of the Canadian public. Today it ranks number one. This in turn is empowering government to enact much tougher regulations. Those companies that are either too entrenched in the old rules or lack the foresight to see the long-term consequences of what is now perceived by the public to be unethical behavior will fail. Whereas those companies which use a combination of ethical foresight and good business, and have the courage to make the changes required, will survive and prosper.

Legislation may provide a level playing field, but legislation alone cannot solve the problem. Similarly, strong corporate statements about environmental values also are useless if business does not have the ethical will to comply with them. The health of our environment depends more than anything else upon corporate moral leadership, which reflects the personal values of executives and employees. And this is where we move from theory to the realm of applied ethics, which is concerned with the practical outcome of business decisions.

Value Judgments

The name of the game is making value judgments in the light of our personal values. I want to say a few words about values so that we can have a common language in this conference.

Values are the criteria by which we make our judgments or choices, and establish our goals and priorities. For most of us, there is a bit of a gap between our ideal personal values and our actual or operative values, and we need to be honest about what our values really are.

The situation is complicated for us today as social values are changing, and this is redefining ethical standards. The ground rules are changing.

Studies have shown the following characteristics resulting from people having clear or unclear values:

Unclear values	***Clear values***
Apathetic	Know who they are
Flighty	Know what they want
Inconsistent	Positive
Drifter	Purposeful
Role player	Enthusiastic
Indecisive	Decisive

Both individually and corporately, it is to our advantage to develop a clear set of values, because confused values will result in confused ethical decisions.

Ethical analysis usually uncovers value conflicts which occur below the surface of our thinking. They can't be settled by rational argument. Only as we listen respectfully to each other's value perspective is it possible to find a reasonable accommodation of the difference. This is why stakeholder analysis is so important.

Rule Ethics

This brings us to the two-basic ethical concepts we will apply in our case study today. The first is rule ethics.

Rule ethics states that you make your decisions about right or wrong on the basis of valid ethical principles, norms or ground rules. In other words, we ask, "Will this proposed action be violating civil law, or company policy in the code of ethics?" This is a good place to start, but as mentioned before, it may not produce ethical decisions. The decisions that result may be legal—but if the ground rules have changed, they may not be ethical.

The next level of rule ethics consists of the rules or principles that come out of our moral traditions, which in our society are mainly the Judeo-Christian moral norms such as "Thou shalt not kill, steal, lie, cheat or oppress."

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The underlying question in rule ethics is, Whose rules are you following? It used to be that the corporation had its own rules, which related only to market forces, and it was not felt to be necessary to consider the values of society. That is, "What's good for General Motors is good for the rest of us." Cynically, the Golden Rule has become, "He who has the gold makes the rules."

Utilitarianism, or End-Point Ethics

John Stuart Mill said that, "To determine whether an action is right or wrong, one must concentrate on its likely consequences—the end point or end result. What is the greatest benefit for the greatest number?"

This led to cost–benefit analysis: does the benefit justify the cost? And to risk–benefit analysis: does not benefit justify the business risk?

In other words, you begin with rule ethics, in which the stakeholders test a decision by asking:

Is it legal?

Is it fair?

Is it right?

Is it environmentally sound?

Then you move to the end-point ethics, which seeks the greatest benefit for the greatest number—and this, finally, forces us to make some trade-offs to achieve the greatest good.

So far, we have been considering the process of ethical analysis. However, there is a tendency to think that having analyzed the problem we have solved it. Unless we take it to the next step of rational problem solving, nothing much is going to happen.

The process I am going to introduce is ethically neutral. The thing that makes it ethical is the particular values and ground rules you apply in the process. If the ethical analysis has been done thoroughly, you will have already sorted out the values that you will apply at the various decision points in the problem-solving process.

Creative problem solving involves lateral thinking, or second-order thinking.

First-order thinking is the obvious course of action that first occurs to the mind of the manager or executive.

Second-order thinking involves "reframing" the problem and considering it from a different perspective.

For example, if you look at a business problem from the perspective of each of the five boxes on the chart, you might generate some creative alternatives which might not come to mind if only the corporate box is considered. It will take courage for every business enterprise to make the ethical shift for a sustainable future, but some can and *are* leading the way.

Graham H. Tucker was the founder and former director of the King-Bay Chaplaincy in Toronto, and former executive director of the Canadian Centre for Ethics & Corporate Policy. Rev. Tucker was the author of *The Faith-Work Connection.*

Source: Tucker, G. "Ethical Analysis for Environmental Problem Solving," *Agenda for Action Conference Proceedings,* The Canadian Centre for Ethics & Corporate Policy, 1990, 53–57.

A FRAMEWORK FOR ETHICAL PROBLEM SOLVING

Consider the following issues while employing the eight steps listed below:

1. **Establish objectivity.**
   Who is doing the analysis and what interests do they represent? What are the ground rules of the company and of the decision-making group?
2. **Scan the situation; identify the problem.**
   Separate out the "core problem" from the subproblems. Whose problem is it? Why is it a problem?
3. **Analyze the problem.**
   Use the "five-box," or "five-question" framework . . . to analyze the situation. What are the operative ground rules or values from the perspective of corporation's existing rules, as well as the legal, public, personal and environmental implications? Who makes the decision? Who are the stakeholders? What are their ground rules? Is it fair to all concerned?
4. **Determine the cause of the problem.**
   Why and how are the rules being broken? Are the rules being broken Prima facie or Categorical? Is there any justification? Specify the cause.
5. **Establish the objective.**
   Describe the desirable outcome, or end-point. Is it achievable? How would you measure it? What is the time frame?
6. **Explore the options.**
   Brainstorm possible solutions. Create alternative cources of action.
7. **Decide on the best solution.**
   Who will be affected by each option? Evaluate the impacts from each option on each group of stakeholders. Which option maximizes the benefits and minimizes the burden? Will it pass the five-box ethics test?
8. **Plan and implement the solution.**