Theories of Ethical Reasoning and Your Business

By Dana Basney
Dana Basney is a retired Managing Director of CBIZ MHM, LLC and a former Shareholder of Mayer Hoffman McCann P.C. He has practiced public accounting for more than 37 years. He is in charge of CBIZ MHM San Diego's litigation support, due diligence, and valuation departments.

Dana holds a Bachelor's Degree in Liberal Arts from Bates College in Lewiston, Maine and received a Master's Degree in Business Administration and Accounting from San Diego State University.

Dana is a licensed CPA and a Certified Reorganization and Insolvency Accountant, as well as a Certified Valuation Analyst. He is a member of The American Institute of Certified Public Accountants, The California Society of Certified Public Accountants, The Institute of Managerial Accountants, The Association of Insolvency Accountants, The Institute of Business Appraisers, Inc., and the Bankruptcy Forum. He has served on the Family Law Bar's Business Valuation Subcommittee and has previously chaired the San Diego Chapter of the CPA Society’s Ethic2s Committee and the San Diego Litigation Support Interest Group of the CPA Society.

Dana has extensive litigation experience and has served as an expert witness in financial and valuation matters on numerous occasions as well as a court appointed mediator and special master. Dana is also an instructor at the University of San Diego where he teaches Accounting Ethics, Fraud Examination and Forensic Accounting. He also teaches Fraud and Ethics courses for the California CPA Education Foundation.

Dana may be reached at: dbasney@att.net or 858.775.9071
Most People Initially Think of Ethics as Being Boring
What is Ethics?

- Accepted standards of behavior
- Practices of those in a profession
- Laws
- Expectations of society
What is Ethics?

- Ethics, derived from the Greek word *ethikos* (character), deals with the concepts of right and wrong; standards of how people ought to act.
- Morals, derived from the Latin word *moralis*, deals with manners, morals, character.
- Ethics and morals are essentially the same.
- Values are basic and fundamental beliefs that guide or motivate attitudes or actions
How Are Business Ethics Defined?

A widely accepted definition of business ethics does not exist.
The best definition of ethics is also the most laconic one

“Knowing what ought to be done and having the will to do it.”

Theories of Ethical Reasoning

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<td>Egoism</td>
<td>Considers rights of stakeholders and related duties to them.</td>
<td>Considers the well-being of others within the scope of deciding on a course of action based on self interest.</td>
<td>Enlightened Egoism</td>
<td>Evaluates consequences of actions (harms and benefits) to stakeholders.</td>
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<td>Values Inputs not Results</td>
<td>ACT: Evaluate whether the intended action provides the greatest.</td>
<td>Those with equal claims to justice should be treated equally; those with unequal claims should be treated unequally.</td>
<td>Rule: Select the action that conforms to the correct moral rule that produces the greatest net benefits.</td>
<td>Judgements are made not by applying rules, but by possessing those traits that enable the decision maker to act for the good of others.</td>
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<td>Treats People as an end and not merely as a means to an end</td>
<td>Universality perspective: Would I want others to act in a similar manner for similar reasons in this situation.</td>
<td>Associated with Immanuel Kant (1724 - 1804), Thomas Hobbes (1588-1679), and John Locke (1632-1704) from the age of enlightenment.</td>
<td>Associated with Jeremy Bentham (1748–1832) and John Stuart Mills (1806 - 1873).</td>
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<td>Problems with Implementation</td>
<td>Relies on moral absolutes - no exceptions; need to resolve conflicting rights.</td>
<td>Fails to consider interest of others affected by the decision.</td>
<td>Interest of others are subservient to self interest.</td>
<td>Can be difficult to assign values to harms and benefits.</td>
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Religious and Philosophical Foundations of Ethics

• A version of the Golden Rule appears in each of the world’s religions
• Ethics can be traced back to ancient Greek philosophy
  ▪ “What is the best sort of life for human beings to live?”
  ▪ Greeks believed the ultimate goal of happiness was to attain some objectively good status: the life of excellence
Deontology

Deontology –
A theory of reciprocal
Rights and duties
Kant's theory is an example of a deontological or duty-based ethics: it judges morality by examining the nature of actions and the will of agents rather than goals achieved. (Roughly, a deontological theory looks at inputs rather than outcomes.) One reason for the shift away from consequences to duties is that, in spite of our best efforts, we cannot control the future. We are praised or blamed for actions within our control, and that includes our willing, not our achieving. This is not to say that Kant did not care about the outcomes of our actions—we all wish for good things. Rather Kant insisted that as far as the moral evaluation of our actions was concerned, consequences did not matter.

As suggested by the first version of the categorical imperative above, if the maxim or rule governing our action is not capable of being universalized, then it is unacceptable. Note that universalizability is not the same as universality. Kant's point is not that we would all agree on some rule if it is moral. Instead, we must be able to will that it be made universal; the idea is very much like the golden rule—Do unto others as you would have them do unto you. If you cannot will that everyone follow the same rule, your rule is not a moral one.

The second version of the categorical imperative given above emphasizes respect for persons. Persons, unlike things, ought never to be merely used.

Deontological ethics is strongest in many of the areas where utilitarianism is weakest. In an ethics of duty, the ends can never justify the means. Individual human rights are acknowledged and inviolable. We need not consider the satisfaction of harmful desires in our moral deliberations. In practice, however, Kant's ethics poses two great problems:

1. Unlike the proportionality that comes out of the utility principle, the categorical imperative yields only absolutes. Actions either pass or fail with no allowance for a "gray area." Moreover, the rigid lines are often drawn in unlikely places. For example, lying is always wrong—even the "polite lie."

2. Moral dilemmas are created when duties come in conflict, and there is no mechanism for solving them. Utilitarianism permits a ready comparison of all actions, and if a set of alternatives have the same expected utility, they are equally good. Conflicting duties, however, may require that I perform logically or physically incompatible actions, and my failure to do any one is itself a moral wrong. (Extracted from the writings of Prof. Charles D. Kay of Wofford College)
Thomas Hobbes – An Early Advocate of Deontological Ethics

- Thomas Hobbes 1588-1679
- Philosopher
- Writer
- Thomas Hobbes was an English philosopher who wrote the 1651 book, *Leviathan*, a political treatise that described the natural life of mankind as "solitary, poor, nasty, brutish and short." Hobbes was educated at Oxford and worked as a tutor to the son of William Cavendish, later the Earl of Devonshire. His connections to the royal family gave him opportunities to travel and pursue his studies, but they also put him in the middle of the English Civil War. In 1640 political turmoil forced him to leave England for France, where he continued to associate with scholars and scientists of Europe, including Galileo and Rene Descartes. In his philosophical works, Hobbes wrote that matter and motion are the only valid subjects for philosophy. In *Leviathan*, he argued that man's natural state is anti-social, and that moral rules are created to avoid chaos. Hobbes's notion that social authority can come from the people -- and not necessarily a monarch -- rankled his royal associates, but helped him reconcile with Oliver Cromwell and the English revolutionaries, and he returned to England shortly after *Leviathan* was published. After the Restoration of 1660, Hobbes was favored by King Charles II, who granted him a pension, but urged him to clear future publications with the throne. Hobbes's "nasty, brutish and short" line is still used often when students and politicians discuss human nature and the proper role of government.

- Source: Who 2 Biographies on the Internet
John Locke

- **John Locke (1632-1704)**
- Philosopher
- John Locke was a 17th-century English philosopher whose ideas formed the foundation of liberal democracy and greatly influenced both the American and French revolutions. His contributions to philosophy include the theory of knowledge known as empiricism, which addressed the limits of what we can understand about the nature of reality. Locke held that our understanding of reality ultimately derives from what we have experienced through the senses. The political implications of his theories included the notions that all people are born equal and that education can free people from the subjugation of tyranny. Locke also believed that government had a moral obligation to guarantee that individuals always retained sovereignty over their own rights, including ownership of property that resulted from their own labor.
- Politically active, Locke was personal physician and advisor to Anthony Ashley Cooper, the Earl of Shaftesbury, a leader in the parliamentary opposition to King Charles II. In 1681 Shaftesbury was accused of conspiring to overthrow Charles and was tried for treason. Although acquitted, he fled to the Netherlands and Locke followed. Locke stayed in exile until 1689, during which time he wrote his masterpiece, *Essay Concerning Human Understanding*, and actively plotted to put William of Orange on the English throne. Locke returned to England after King James II fled and William was crowned William III (in the turn of events known as the Glorious Revolution). Over the next several years he published his most important works, including *A Letter Concerning Toleration* (1689), *Two Treatises on Government* (1690) and *Some Thoughts Concerning Education* (1693).
- Source: Who 2 Biographies on the internet

- “Every man has an immortal soul that is capable of eternal happiness or misery. Its happiness depends on his believing and doing the things that he needs to believe and do if he is to obtain God’s favour—the things that are prescribed by God for that purpose.”
Deontological Ethics are Sometimes Derived From Religious Values – The 10 Commandments is an Example

King James Bible Version of The 10 Commandments

• Thou shalt have no other gods before me.
• Thou shalt not make unto thee any graven image, or any likeness of any thing that is in heaven above, or that is in the earth beneath, or that is in the water under the earth.
• Thou shalt not take the name of the Lord thy God in vain
• Remember the Sabbath day, to keep it holy.
• Honor thy father and thy mother Thou shalt not kill.
• Thou shalt not commit adultery.
• Thou shalt not steal.
• Thou shalt not bear false witness against thy neighbour.
• Thou shalt not covet thy neighbour’s house, thou shalt not covet thy neighbour’s wife, nor his manservant, nor his maidservant, nor his ox, nor his ass, nor any thing that is thy neighbour’s.
Deontological Principles Strongly influenced the founding fathers
In the Declaration of Independence

IN CONGRESS, July 4, 1776.
The unanimous Declaration of the thirteen united States of America,
When in the Course of human events, it becomes necessary for one people to dissolve the political bands which have connected
them with another, and to assume among the powers of the earth, the separate and equal station to which the Laws of Nature and
of Nature's God entitle them, a decent respect to the opinions of mankind requires that they should declare the causes which
impel them to the separation.

We hold these truths to be self-evident, that all men are created equal, that they are endowed by
their Creator with certain
unalienable Rights, that among these are Life, Liberty and the pursuit of Happiness.--That to
secure these rights,
Governments are instituted among Men, deriving their just powers from the consent of the
governed, --That whenever any
Form of Government becomes destructive of these ends, it is the Right of the People to alter or to abolish it, and to institute new
Government, laying its foundation on such principles and organizing its powers in such form, as to them shall seem most likely to
effect their Safety and Happiness. Prudence, indeed, will dictate that Governments long established should not be changed for light
and transient causes; and accordingly all experience hath shewn, that mankind are more disposed to suffer, while evils are
sufferable,
than to right themselves by abolishing the forms to which they are accustomed. But when a long train of abuses and usurpations,
pursuing invariably the same Object evinces a design to reduce them under absolute Despotism, it is their right, it is their duty, to
throw off such Government, and to provide new Guards for their future security.--Such has been the patient sufferance of these
Colonies; and such is now the necessity which constrains them to alter their former Systems of Government. The history
of the present King of Great Britain is a history of repeated injuries and usurpations, all having in direct object the establishment
of an absolute Tyranny over these States. To prove this, let Facts be submitted to a candid world.
Deontology

• Deontology differs from utilitarianism in that moral norms or rules are based on reason, not outcomes. Fundamental to Deontological theories is the idea that equal respect must be given to all persons. In other words, individuals have certain inherent rights and I, as a decision maker, have a duty (obligation, Commitment, or responsibility) to respect those rights.

• The rights and duties are correlative. That is my rights establish your duties, and my duties correspond to your rights.

• "I disapprove of what you say, but I will defend to the death your right to say it," is widely attributed to Voltaire (François Marie Arouet: 1694–1778) It embodies Deontological Principles.
Limitations of Deontology

Can you name a situation where you have competing rights which would be difficult to resolve Using Deontology?
Limitations of Deontology

- The Christian Baker and The Lesbian Couple
- A Woman’s Reproductive rights versus a baby’s right to life
Teleology or Consequential Ethics

Teleology –
A theory that judges an act based on its anticipated consequences and Benefits
Teleological or Consequential Ethics

- Eqtism – Makes Decisions based on the consequences to the decision maker (Fair to me!)
Teleological or Consequential Ethics

- Enlightened Egoism – Makes Decisions based on the consequences to the decision maker but considers the benefits and consequences to others
Can you name a situation in business where the business actions are guided by enlightened Egoism?

Is this a bad thing?
Teleological or Consequential Ethics

- Enlightened egoism is beneficial to all – it is generally a good thing, even if anchored in self interest
- Is like the Hindu believe in Karma – (what goes around come around)
Teleological or Consequential Ethics

After 45 years in business your speaker is a big believer in Karma – what goes around comes around!

My most memorable experience with Karma involved an unscrupulous lawyer who was murdered
Teleological or Consequential Ethics

- Utilitarianism is the philosophy that a moral act is one which produces the greatest happiness for the greatest number of people.

- Jeremy Bentham, an eccentric English college professor (1748-1832), was instrumental in developing this school of ethics.
Jeremy Bentham (1748-1832) was a key founder of Utilitarianism -- simply put, the philosophy that a moral act is one which produces the greatest happiness for the greatest number of people. Bentham outlined this theory in his 1789 work, Introduction to the Principles of Morals and Legislation. Bentham's outlook made him a vocal critic of many legal and political institutions, and he was considered quite radical for his day. (He was particularly critical of Sir William Blackstone, author of Blackstone's Commentaries and the most famous English legal mind of that era.) Jeremy Bentham also is known for an odd request in his will: he ordered that his remains be preserved and kept in a box, to be displayed on occasion to friends and followers. This "auto-icon," duly dressed in Bentham's own clothes, is kept in a special cabinet at University College London to this day.

Jeremy Bentham strongly influenced the philosopher John Stuart Mill, who wrote the 1861 book Utilitarianism...

Bentham entered Queen's College, Oxford at age 12 and graduated in 1764.

Source: Who 2 Biographies on the Internet
The Mysteries of Bentham’s Head

It is believed that Jeremy Bentham originally intended his 'real' head to be preserved and placed on top of the auto-icon, and in fact the mummified head does show evidence of having been attached. However very soon it was decided that the head was inappropriate for display and a new wax version was commissioned and made by a French artist, Jacques Talrich.

After this the head appears to have stayed with the auto-icon, as during an inspection in 1898 'The head was found, wrapped in cloth saturated with some bituminous or tarry substance (a sort of tarpaulin) and then in paper, making a parcel, in the cavity of the trunk-skeleton, being fastened by strong wire running from the ribs to the vertebral column'.

Although records relating to the head are vague it seems that it was displayed between the feet of the auto-icon for some time, until worries about its condition, security and the ethics of display of human remains caused it to be removed from public view.

The head was kidnapped by students from King's College Students in October 1975. It was returned unharmed following the payment of a ransom of £10 to the charity Shelter.

In 2002 the head was moved to safe storage at the University College of London (formerly the University of London) Institute of Archaeology, where it is stored in a climate controlled storeroom and continually monitored by conservation staff.
Jeremy Bentham

Recently scientist are attempting to test Bentham’s DNA to see if he was autistic. His unusual and eccentric behavior is consistent with Asberger’s Syndrome, which is a form of autism associated with individuals of superior IQ’s.
John Stuart Mills

- **John Stuart Mill**, (1806 – 1873) was a British philosopher, political economist and civil servant. He was an influential contributor to social theory, political theory and political economy. He has been called "the most influential English-speaking philosopher of the nineteenth century". Mill's conception of liberty justified the freedom of the individual in opposition to unlimited state control.

- Mill expresses his view on freedom by illustrating how an individual's amelioration of personal quality and self improvement is the sole source of true freedom. That only when an individual is able to attain such a beneficial standard of one's self, whilst in the absence of rendering external onerousity upon others, in their own journey to procure a higher calibre of self worth, that true freedom resides. Mill's attitude toward freedom and individual accomplishment through self improvement has inspired many throughout time. By establishing an appreciable level of worthiness concerned with one's ability to fulfill personal standards of notability and merit, Mill was able to provide many with a principle example of how they should achieve such particular values.

- He was a proponent of utilitarianism, an ethical theory developed by Jeremy Bentham. He was also concerned about limiting what he called "The tyranny of the majority" and advocated individual self improvement as the road to happiness.

Limitations of Teleogical Ethics

- We cannot foresee the future consequences of our actions with any accuracy

- There is something to be said for the old adage “The road to hell is paved with good intentions”
Limitations of Teleogical Ethics

- The low income housing credit

- The lowering of lending standards designed to increase home ownership and benefit minorities who might have difficulty accessing credit
Limitations of Teleogical Ethics

- Can lead to the tyranny of the majority (Note the recent vilification of the “Top One Percent”)
- Can result in ignoring basic human rights in making decisions based on an economic calculation of benefits
The Ford Pinto Case – Egoism and Utilitarian analysis ignores fundamental human right to life. Teleology trumped Deontology with disastrous results for everybody.
Virtue Ethics

Virtues Ethics –

- Stresses personal character traits needed to live the good life - integrity, honesty, fairness
- Is the foundational ethical philosophy for most professional codes of ethics including Accounting
Virtue Ethics

- Traces its Origin’s back to the ancient Greeks – Plato and Aristotle
- Is an Ethics emphasizing Personal Character and the elements of a good life –
- Maintains a virtue-based eudaemonistic conception of ethics. That is to say, human well-being (eudaimonia) is the highest aim of moral thought and conduct
- The virtues (aretē: ‘excellence’) are the requisite skills and dispositions needed to attain it
Plato is perhaps the most influential philosopher of all time, and he is widely regarded as the first truly systematic thinker in Western intellectual culture.

Plato is the originator of several highly regarded ideas in Western philosophy, including the longest revered branch of ethical philosophical thought: virtue ethics.

**Virtue Ethics**
Contemporary philosophers still disagree on what exactly the term "ethics" means. Many such philosophers today consider ethical language to be nothing more than a moral fiction. Nevertheless, the general consensus in the field diverges among three major branches: consequentialism, deontologicalism and virtue ethics. The first two are relatively recent ideas, but virtue ethics has been around since the time of Plato. Virtue ethics focuses on the idea that what we call good is not dependent on the actions we take (deontologicalism) nor the results of those actions (consequentialism), but instead focuses on the person that we are.

To a virtue ethicist like Plato, actions are only good to the extent that virtuous persons take such actions. When Plato talks about what is good, he always means for us to think of an ideal good person. In this way, Plato would agree wholeheartedly with the basic idea of the What Would Jesus Do? movement, since the focus is on what a good person is, rather than what good actions or good consequences are.

*Source: Eric Herboso, Demand Media*
Plato’s Ethics: An Overview

Like other ancient philosophers, Plato maintains a virtue-based eudaemonistic conception of ethics. That is to say, human well-being (eudaimonia) is the highest aim of moral thought and conduct, and the virtues (aretē: ‘excellence’) are the requisite skills and dispositions needed to attain it. If Plato's conception of happiness is elusive and his support for a morality of happiness seems somewhat subdued, there are several reasons. First, his conception of happiness differs in significant ways from ordinary views. In his early works his approach is largely negative: Socratic questioning seems designed to undermine the traditional values rather than to develop a positive account of his own. Second, the positive accounts contained in his later works, especially that of the Republic, treat happiness as a state of perfection that is hard to comprehend because it is based on metaphysical presuppositions that seem both hazy and out of the realm of ordinary understanding. In other dialogues he confines himself to intimations of different aspects of what is good in and for the soul, intimations that are hard to fit together in a coherent picture. There is not, as there is in Aristotle, much talk about happiness as a self-sufficient state of the active individual. Third, in crucial texts Plato's moral ideals appear both austere and self-abnegating: the soul is to remain aloof from the pleasures of the body; communal life demands the subordination of individual wishes and aims. Plato’s Philosophy is more aimed at developing a good soul than a happy life. Aristotle was his student.

The difficulties of assessing Plato's ethical thought are compounded by the fact that it was subject to various modifications during his long life.

Source: Stanford Encyclopedia of Philosophy
Aristotle – An Early Proponent of Virtue Ethics

• Aristotle (384 BC - 322 BC) was a student of Plato and the tutor of Alexander the Great. Aristotle believed that the virtuous man was formed from values instilled in youth and that virtue and reason should guide our actions.

• *Nicomachean Ethics* and *Eudemian Ethics* are Aristotle’s major treatises on the behavior and judgment that constitute “good living.” In *Politics*, Aristotle examined human behavior in the context of society and government.

• Aristotle’s philosophy not only provided man with a system of reasoning, but also touched upon ethics. In *Nicomachean Ethics*, he prescribed a moral code of conduct for what he called “good living.”

• His Ethics stressed individual virtues. He asserted that good living to some degree defied the more restrictive laws of logic, since the real world poses circumstances that can present a conflict of personal values. That said, it was up to the individual to reason cautiously while developing his or her own judgment.
• “Jealousy is both reasonable and belongs to reasonable men, while envy is base and belongs to the base, for the one makes himself get good things by jealousy, while the other does not allow his neighbor to have them through envy.”

• “In a democracy the poor will have more power than the rich, because there are more of them, and the will of the majority is supreme”

• “The worst form of inequality is to try to make unequal things equal.”

• Aristotle (Source: www.brainyquote.com)
The Theory of Social Justice

- Attributed to Harvard Professor John Rawls
- Has two major Principles as propounded by Rawls – The principle of Equal opportunity and the Differentiation Principle
- The Differentiation Principle is unworkable in the opinion of your speaker and could only have come from a Harvard left wing Egg Head
Justice as fairness as an illustration of a political conception of justice. In its mature form this notion affirms the following principles:

I. Each person has an equal right to a fully adequate scheme of equal basic liberties which is compatible with a similar scheme of liberties for all,

II. Social and economic inequalities are to satisfy two conditions. First, they must be attached to offices and positions open to all under conditions of fair equality of opportunity; and second, they must be to the greatest benefit of the least advantaged members of society. The first of these is sometimes referred to as the Equal Liberty Principle.

The stem of the second ("Social and economic liberties are to satisfy [the condition that]") together with the first condition is called the Principle of Equal Opportunity. The stem of the second together with the second condition is called the Difference Principle.

John Rawls, *Political Liberalism* (Columbia University Press, 1996);
What does Rawls' Second Principle mean?

It means that society may undertake projects that require giving some persons more power, income, status, etc. than others, e.g., paying accountants and upper-level managers more than assembly-line operatives, provided that the following conditions are met:

(a) the project will make life better off for the people who are now worst off, for example, by raising the living standards of everyone in the community and empowering the least advantaged persons to the extent consistent with their well-being, and (b) access to the privileged positions is not blocked by discrimination according to irrelevant criteria.

The second principle contains elements of other familiar ethical theories. The "socialist" idea that responsibilities or burdens should be distributed according to ability and benefits according to need is partly contained within the Difference Principle. We may reasonably assume that the "least advantaged" have the greatest needs and that those who receive special powers (hinted at under "social inequalities") also have special responsibilities or burdens. However, the merit principle that the use of special skills should be rewarded is also included in the Difference Principle. What the Difference Principle does not permit is a change in social and economic institutions that makes life better for those who are already well off but does nothing for those who are already disadvantaged, or makes their life worse.
Problems with John Rawl’s Theories

The idea that burdens should be distributed according to ability and benefits according to need is partly contained within the difference Principle of Rawls. It is not a new concept. (Remember Karl Marx’s Communist theory stated “From each according to his abilities, to each according to his needs.”)

1. It assumes that Allocation decisions are made by disinterested persons without considering their own self interest – Do such persons exist?
2. It does not say who determines what is socially beneficial? Are such decisions made by Bureaucratic Czars? Obviously all the people can’t vote on every decision.
Problems with John Rawl’s Theories

3. It removes incentive to work if all get equal benefits and society regresses and as a result is doomed to fail just as communism has been an economic and civil liberties disaster in every country it has been tried in.

4. It lends itself to demagoguery and the politics of envy where leaders appeal to the masses by redistributing wealth to make them dependent of government and enhance the control of the Demagogue. (This is nothing new – it goes back to ancient Rome and beyond)
Problems with John Rawl’s Theories

5. It ignores the rights of the wealthy and the overall betterment of society. It concentrates on distributing equal portions of the pie – not making a bigger pie!

6. It's more of a societal approach – not an individual approach to ethical behavior.
You Should Have Policies to Address Unethical and Illegal Conduct and procedures to Address these issues
The Tone at the Top

• this is a broader concept than internal accounting controls it encompasses all ethical behavior

• all public companies should develop and enforce effective, written codes of corporate conduct

• a company's audit committee should annually review the program that management establishes to monitor compliance with the code
The Tone at the Top

Organizational Ethics Policy
The Fraud Triangle

Dr. Donald Cressey (1919-1987)
His Research showed that there are three elements that must be present for occupational fraud.
Duties of Directors and Officers

- **Duty of Care**
  - Fiduciaries
  - Ethical & legal duties to the corporation and to the shareholders
  - Due care (specifies how directors must discharge their legal responsibilities, not the substance of their decisions)
    - Good faith
    - Care of prudent person in similar situation
    - Act in best interests of company
  - Liable for negligence
- **Duty of Loyalty**
  - Requires directors to act in best interests of company
  - Faithfulness to one’s obligations and duties
  - Subordinate personal interests to welfare of organization
  - Refrain from self-serving
- **Duty of Good Faith**
  - Honesty of purpose; caring for well-being of stakeholders
Liability of Directors and Officers

- Crimes and torts committed by themselves and by employees under their supervision
- Shareholder’s derivative suit; *(Caremark & Citigroup Subprime Lending)*: test is rooted in concept of “bad faith”
- Directors liable for their actions and inactions
- **Business Judgment Rule**
  - Used to avoid liability for poor business judgments
    - Honest mistakes of judgment
    - Poor business decisions
  - Complies with fiduciary duties
  - Acting within powers of the corporation
  - Reasonable basis for decision
  - Applies to audit committee only when acts relate to business judgment
Caremark Opinion

- Caremark International investigation was precedent setting for directors obligations
- Violations of Medicare’s antireferral law
- Delaware Court of Chancery ruled that directors have affirmative fiduciary obligation to ensure adequate information and reporting systems exist
Clawback of Incentive Compensation from Executive Officers

- Public companies need to “clawback” incentive based compensation to senior executives from 3 years prior to when financial restatement occurs
  - Dodd Frank requires stock exchanges to have rules about this to list on the exchange
  - SOX and Dodd Frank have different requirements
  - SEC v Michael A. Baker and Michael T. Gluk: SEC can force CEOs and CFOs of companies that violated securities laws to surrender their bonuses and stock options
Legal Liability: An Overview

- Auditors can be sued by clients, investors, creditors, and the government
- Auditors can be held liable under two classes of law

**Common law**
- Evolves from legal opinions issued by judges in deciding a case
- Breach of contract is a claim that accounting or auditing services were not performed in manner proscribed in the contract (brought by clients)
- Tort actions cover other civil complaints (brought by clients and users of financial statements)
  - Fraud
  - Deceit

**Statutory law**
- Legislation passed at state or federal level that establishes certain courses of conduct that must be adhered to by parties
Auditor Liability to Third Parties for Fraud

- Plaintiff must prove: (1) a false representation by accountant; (2) knowledge or belief by the accountant that the representation was false; (3) accountant intended to induce third party to rely on false representation; (4) third party relied on the false representation

- State Street Trust v. Ernst: Gross negligence may be interpreted as fraud

- Gross negligence, or constructive fraud, occurs when the auditor acts so carelessly in the application of professional standards that it implies a reckless disregard for the truth/standards of due care

- Plaintiff must show Fraudulent intent or **sciente**r
• **Scienter** is a legal term that refers to intent or knowledge of wrongdoing. This means that an offending party has knowledge of the "wrongness" of an act or event prior to committing it. For example, if a man sells a car with brakes that do not work to his friend, but the seller does not know about the brake problem, then the seller has no *scieler*. If he sells the car and knew of the problem before he sold the car, he has *scieler*.
When You Have an Ethical Problem

Your first call should be to a lawyer!

Always consult a lawyer- Remember Attorney Client privilege
Ethical Issues Are Not Always Obvious
Ethics in Private Industry

Questions

???