

Chapter 6

Placing False Hope in the “Ethical Organization”

In 2009, a group of thirty-three second-year MBA students at Harvard Business School wrote an oath that they asked their fellow students at Harvard to sign. The signatories vowed that, upon entering the workforce as managers, they would serve the greater good, act ethically, and refrain from self-interested acts within their organizations (see the oath at right). Within weeks, more than half of Harvard’s 2009 MBA class had signed the oath. Soon it went viral, attracting signatures from large numbers of students and graduates of different MBA programs around the world. Some view the oath as a promising sign that new MBAs were rejecting the scandals of the recent past, such as the Bernard Madoff and AIG bonuses, and signaling a new era of corporate social responsibility.

While the attention that the oath brought to the issue of business ethics is valuable, the oath has attracted criticism as well. “There’s no cost,” Scott Holley, a 2009 Harvard MBA graduate and oath signer, told *Business-Week*. “You say the oath, and you’re done.”¹ Not only did Holley believe the oath would have little impact on managers’ behavior, he thought it could become a symbol of hypocrisy if any of the signatories was later involved in an ethical scandal. Holley speculated that those most likely to sign the oath were those who had no intention of complying with it. Other critics have noted that the broad scope of the oath creates a potential clash of goals—such as balancing shareholder interests with the desire to protect the natural environment—that would be difficult to resolve. And some have commented that the oath could be moot if organizational leaders make unethical decisions that undermine the good intentions of individual managers.

THE MBA OATH

As a manager, my purpose is to serve the greater good by bringing people and resources together to create value that no single individual can create alone. Therefore I will seek a course that enhances the value my enterprise can create for society over the long term. I recognize my decisions can have far-reaching consequences that affect the well-being of individuals inside and outside my enterprise, today and in the future. As I reconcile the interests of different constituencies, I will face choices that are not easy for me and others.

Therefore I promise:

- **I will** act with utmost integrity and pursue my work in an ethical manner.
- **I will** safeguard the interests of my shareholders, co-workers, customers and the society in which we operate.
- **I will** manage my enterprise in good faith, guarding against decisions and behavior that advance my own narrow ambitions but harm the enterprise and the societies it serves.
- **I will** understand and uphold, both in letter and in spirit, the laws and contracts governing my own conduct and that of my enterprise.
- **I will** take responsibility for my actions, and I will represent the performance and risks of my enterprise accurately and honestly.
- **I will** develop both myself and other managers under my supervision so that the profession continues to grow and contribute to the well-being of society.
- **I will** strive to create sustainable economic, social, and environmental prosperity worldwide.
- **I will** be accountable to my peers and they will be accountable to me for living by this oath.

This oath I make freely, and upon my honor.²

Potentially countering these negative perceptions is the fact that companies and institutions are already spending a great deal of time and money to improve their ethicality. Ethics programs, which include initiatives such as instating codes of ethics, ombudsmen, and ethics training, are designed to convey the values of an organization and the ethical standards the organization expects its employees to meet. In addition, compliance programs, an increasingly important element of ethics programs, are being designed to ensure that organizations meet governmental regulations in the ethics domain. In response to the ethics scandals of the 1990s, for instance, the Sarbanes-Oxley Act of 2002 requires all 9,000 publicly held corporations in the United States to employ “in-house watchdogs,” or compliance officers—a position almost unheard of prior to 2002. At Sun Microsystems, the chief compliance officer holds ethics “boot camps” for employees, focusing on business ethics and compliance with Sarbanes-Oxley.³ The company has developed and translated its online courses on federal compliance into at least nine languages. All 32,000 Sun employees are required to take the course, making it the first required training course in the company’s history.

The use of compliance initiatives to improve organizational ethics isn’t limited to companies that trade on Wall Street. In university athletics, “Compliance officers have become an athletic department’s most important employee,” writes the *New York Times*.⁴ In a world where violations of intercollegiate rules and regulations can wreak havoc on coaches, players, and the university’s reputation, ensuring that everyone plays “by the books” is increasingly viewed as a critical mission.

These initiatives don’t come cheap. A recent survey of 217 large firms indicated that for every billion dollars in revenue earned, the average company spends one million dollars on

compliance initiatives.⁵ At Sun Microsystems, the costs of compliance initiatives, including the time employees spend in compliance training courses, accountant and auditor fees, and costs borne by the controller's office, are estimated to exceed \$6 million annually. If these efforts worked, many might argue that these dollars—just a drop in the bucket for many companies—are well spent. But that's a big if. As we have highlighted, despite all of the time and money that has been spent on these efforts and all of the laws and regulations that have been enacted, unethical behavior appears to be on the rise.

These results, while disappointing, were predictable. Even the most well-intentioned oaths and ethics programs will fail if the concept of bounded ethicality is not taken into account. One problem with ethics programs is that they assume employees are aware of the rules and know what they need to do to comply with them. As noted in chapters 3 and 4, however, bounded ethicality and ethical fading may obscure whether ethical behavior, and compliance, is even relevant in a given situation.

Oaths, compliance systems, and other organizational attempts at encouraging ethical behavior are not only failing to meet their goal of curbing unethical behavior in most cases, but can actually *promote* unethical behavior. Why? Because the architects of such systems often neglect to consider how the structure of these programs inadvertently influences unethical behavior. Consider that ethics programs are usually predicated on formal systems that hand out rewards for ethical behavior and punishment for unethical behavior. Such efforts are doomed because of the way individuals respond to these rewards and punishments. Moreover, even if we could design a program that took these behavioral responses into account, it still wouldn't be sufficient. Formal ethics and compliance programs represent only the tip of an organization's "ethical infrastructure."⁶ Underlying formal systems are informal norms and pressures that exert far more influence on employee behavior than any formal efforts could. In addition to exploring how individuals react to the incentives of compliance systems, behavioral ethics digs deep into organizations: past their formal ethics programs and into the informal systems that teach employees what behavior is *really* expected of them.

Reward Systems Gone Awry

To understand the flaws built into most organizational ethics programs, consider the case of a parent who is trying to encourage his child to make her bed in the morning. The parent gives the child a star each time she makes the bed, and she can later cash in her stars in exchange for valued toy purchases. The parent is proud of this system, and it seems to work. Each day, the child makes her bed. Soon, however, the parent notices that the child, who used to be in charge of emptying the wastebaskets, is no longer doing so consistently. Upon further investigation, the parent learns that the child doesn't actually make her bed; she simply flattens the comforter on top of her unmade bed.

Like a reward system for chores, the goals of formal ethics programs—to decrease unethical behavior and increase ethical behavior—are commendable and, most likely, have few

opponents. The reward systems that are built into these formal programs are based on the underlying premise of goal-setting research: Individuals seek information about behaviors that will be rewarded and then strive to perform well on those behaviors. Yet the downside to goal setting has been ignored, with perilous results. In fact, goals can create systematic problems. Specifically, they can encourage employees to

1. focus too narrowly on their goals, to the neglect of nongoal areas;
2. engage in risky behavior;
3. focus on extrinsic motivators and lose their intrinsic motivation;
4. and, most importantly from our perspective, engage in more unethical behavior than they would otherwise.⁷

Consider the recent financial crisis and its link to faulty reward systems. President Bill Clinton's objective of increasing homeownership by rewarding potential home buyers and lenders is one example. The Clinton administration "went to ridiculous lengths" to increase homeownership in the United States, promoting "paper-thin down payments" and pushing lenders to give mortgage loans to unqualified buyers, according to *BusinessWeek* editor Peter Coy. "It's clear now that the erosion of lending standards pushed prices up by increasing demand," writes Coy, "and later led to waves of defaults by people who never should have bought a home in the first place."⁸

Increasing the percentage of Americans who own a home arguably could be a commendable goal, one that, if accomplished, could result in a more just and ethical society. But Clinton and others who promoted this goal overlooked the way in which such goals change behavior, often in ways that are unintended and undesirable. In this case, the goal of increasing home ownership inadvertently spurred unethical lending by banks and risky decision making by consumers. Artificially imposed rewards, including low interest rates and down payments, were at the center of the epidemic of poor decision making.

To take a more historical example of a governmental initiative to promote ethical behavior and expose unethical behavior, the False Claims Act was passed in 1863 to address fraud by Union Army defense contractors during the Civil War. The act allows individuals and organizations who are unaffiliated with the U.S. government to file a claim against individuals and federal contractors that they believe have directly or indirectly defrauded the government. The goal of the act is to encourage citizens to become whistleblowers by exposing unethical behavior of which the government may be unaware. After a whistleblower files a lawsuit documenting alleged offenses in a U.S. district court, the Department of Justice conducts an investigation and decides whether to pursue the case. The *qui tam* provision of the act stipulates that whistleblowers who expose such cases will be rewarded a percentage of the money that the government recovers, with rewards as high as 30 percent of the recovery amount. Those rewards can be quite substantial: A recent settlement, based on TRW's efforts to prevent a scientist from revealing information about faulty electronic components the company sold to the government, was settled for \$325 million; \$48.8 million of this amount was awarded to the whistleblower and his attorneys.⁹

Clearly, the False Claims Act is well intentioned. It was designed to give citizens a strong incentive to take the personal and professional risks involved in reporting fraud. However, basing rewards on total damages could actually encourage prospective whistleblowers to delay reporting a known fraud, and even to actively participate in its continuance, in order to run up the total amount of damages incurred by the government and thus their percentage of the take.¹⁰ Because of the potential corruption created by this faulty reward system, the reporting of wrongdoing can actually *increase* unethical behavior.

Organizational and governmental leaders have a responsibility to analyze how employees and citizens are likely to respond to proposed incentive systems. But as these examples demonstrate, the architects of reward systems often fail to consider how efforts to accomplish a target goal will cause decision makers to ignore ethical problems in other areas. Reward systems can promote a “whatever it takes” attitude that can be a powerful catalyst for unethical behavior. Such systems can be so effective in directing attention to the “ends”—the potential rewards of compliance and cooperation—that people overlook the means by which they will achieve the goal. As we argued in [Chapter 5](#), the competition and reward systems in Major League Baseball encouraged players and management to meet the goal of winning at any cost, a focus that resulted in a failure to see players’ widespread abuse of steroids. For many years, players, who had a narrow window of time in which to cash in on their skills, faced little to no penalties for using steroids.

Corporations affect ethics in numerous ways, many of which have little explicit connection to ethics—until the unethical actions occur and become public. Consider what happened in the early 1990s when Sears gave its automotive mechanics a sales goal of \$147 an hour. To meet this goal, employees overcharged for their services companywide and sold unnecessary repairs to customers. After the scandal was exposed, the company’s chairman, Edward Brennan, admitted that the “goal setting process for service advisers created an environment where mistakes did occur.”¹¹ The focus on racking up billable hours in accounting, consulting, and law firms creates similarly perverse incentives. Employees end up engaging in unnecessary and expensive projects to meet their often-unrealistic billable hour goals.

Psychologists Barry Staw and Richard Boettger have provided a powerful demonstration of what happens when individuals are told to focus narrowly on achieving a single goal.¹² They asked college students to proofread a paragraph that they were told would be used in a brochure promoting the university’s business school. Grammatical and content errors were embedded within the paragraph. Some of the students were told to simply “do your best” when correcting the paragraph. Others were told to focus on correcting grammar mistakes. The researchers found that students who were instructed to “do your best” were more successful at finding both grammatical and content errors than those who were told to focus on correcting grammar mistakes. A narrow goal—namely, the instruction to find grammatical errors—led individuals to overlook obvious content errors.

In the U.S. health-care system, the focus of for-profit insurance companies on a primary goal—profits—has led to ethical lapses when it comes to meeting other goals, such as health-care delivery. In the midst of his 2009 push for health-care reform, President Obama delivered a

speech to Congress in which he accused insurance companies of cherry-picking healthy clients and dropping sick ones. He cited the case of Robin Beaton, a Texas woman whose insurance company canceled her scheduled surgery for advanced-stage breast cancer because she forgot to disclose that she had recently been treated by a dermatologist for acne. According to Obama, the insurance companies make such unethical decisions because they are rewarded for doing so. "They do it because it's profitable," Obama said. "As one former insurance executive testified before Congress, insurance companies are not only encouraged to find reasons to drop the seriously ill; they are rewarded for it. All of this is in service of meeting what this former executive called 'Wall Street's relentless profit expectations.'"¹³

We don't find fault with the notion that insurance companies and other businesses should earn profits; in fact, we believe they should. Rather, we blame the reward systems that, by putting the goal of high profits above all others, leave ethical considerations in the dust.

One reason one-dimensional goals fail is because they cause individuals to be driven by an extrinsic motivation to comply rather than by an intrinsic motivation to do what's right. Let's return to the problem of accurate reporting of billable hours in the legal, accounting, and consulting fields. Some U.S. law firms have taken steps to increase the transparency of billable hours in an effort to encourage employees to be more honest about where and how they spend their time. This admirable goal translates into requirements for more detailed reporting of one's time. In some cases, these requirements have generated literally hundreds of codes for specific activities that a legal professional might undertake for a client. One would think that such fine-grained accountability would increase the honesty of reporting, but that's not necessarily the case. Lawyers have told us that such detailed accounting has the reverse effect. Trying to decide whether a specific research activity falls under category "x.1.2" or "z.2.4" involves some guesswork, they tell us—guesswork that soon becomes a natural component of the billable hour. Small guesses becomes large guesses, and a system designed to promote ethical behavior backfires.¹⁴

Even when employees do consider multiple goals, the unbalanced attention they give to a primary goal tends to overshadow goals that are less rewarded and therefore viewed as less important. Profit concerns tend to dwarf sustainability efforts; similarly, the goal of on-time delivery can cause firms to sacrifice quality. The case of corporate quarterly earnings is another telling example. Research shows that, in comparison to firms that issue longer-term earnings reports, firms that issue quarterly reports accomplish their primary goal of meeting or beating analyst expectations. However, these firms also devote fewer resources to the less publicized, less rewarded (in the short term) goal of investing in research and development.¹⁵ By focusing on meeting quarterly earnings goals, firms become distracted from other important goals, such as investing in their long-term viability. Moreover, many firms manipulate data to reach their quarterly goals or earning expectations, sacrificing long-term performance in the process. General Electric, for example, was fined \$50 million by the SEC for pretending it had sold 100 locomotives that were actually sitting idle, a move many analysts believed was driven by the desire to meet or beat earnings expectations.¹⁶

Reward systems are usually well intentioned, yet they tend to miss the mark because they

fail to anticipate how employees will respond to them. They are simplistic, focusing on a single objective. By ignoring how employees will achieve outlined goals, they produce unintentional behavior, and they discourage desirable behaviors that aren't rewarded. Like the child who is rewarded for making her bed, employees fail to take out the trash.

How can organizations design more ethical incentive systems? Most obviously, when setting goals for their members, they must try to take the perspective of those whose behavior they are trying to influence and think through their likely responses. Wall Street analysts and others who are responsible for evaluating firms' health need to think through the consequences of heavily weighting short-term earnings. By anticipating the potentially adverse behavior their reports and statements could promote, decision makers may find they have overlooked goals that are just as important to reward, if not more important, such as honest reporting. Given that the provision of accurate valuations is arguably our financial system's most important goal, leaders need to modify the system to include multiple, attainable objectives and appropriate checks and balances. When they fail to meet this responsibility, they can be viewed not only as promoting unethical behavior, but as engaging in it themselves.

The Unintended Effects of Sanctions

In addition to encouraging ethical behavior through rewards, ethics and compliance programs often include sanctioning systems that attempt to discourage *unethical* behavior, typically through punishment. Yet these programs often have the reverse effect, *encouraging* the very unethical behavior they are supposed to discourage.

In a set of experiments, Ann and her colleague David Messick found that the implementation of a compliance system can actually increase the undesirable behaviors the system was designed to decrease.¹⁷ In one study, individuals played the role of a manufacturer in an industry that emits toxic gases. The participants were told that they and the other manufacturers in their industry were concerned that environmental groups would soon target them for emitting pollutants and that such attention would result in costly legislation and expensive "clean" solutions. Participants learned that, to avoid scrutiny from environmental groups, the manufacturers in their industry had met as a group and reached an agreement to run their "scrubbers" 80 percent of the time to clean up some of their emissions. The manufacturers saw this solution as a way to appease the environmentalists. Although running scrubbers is expensive, the manufacturers realized this strategy was less expensive than the legislation and compliance costs that would result if the environmental groups took the industry to task.

Each participant, playing the part of a manufacturer, was presented with the decision of whether to keep her company's promise and run the scrubbers or to renege on the promise and not run the scrubbers. Imagine that you are in the position of manufacturer X, who knew that his decision regarding whether or not to run the scrubbers would have no impact on whether the environmentalists came after the industry. Why? Because if every other manufacturer kept the promise and ran their scrubbers, then the total emissions level would fall below the radar. The

environmentalists would leave the industry alone, whether or not manufacturer X ran its scrubbers. If, on the other hand, every other manufacturer abandoned the promise, then the continued high emissions levels would attract the attention of the environmentalists, and nothing manufacturer X could do would change that. So, independent of what the other manufacturers decided, manufacturer X knew that his least expensive option would be to renege on his promise and not run his scrubbers.

We told half of our participants that there would be no compliance system—in other words, that none of the manufacturers would be monitored or sanctioned to determine whether or not they were adhering to their promise. The other half were told that a compliance system would be in place, such that a small percentage (5 percent) of the manufacturers would be subject to random monitoring to check whether or not they were adhering to the agreement; if they were found to be in violation, they would be sanctioned and subject to a minimal fine.

Did their participants cooperate with the group, or did they behave unethically? As it turned out, whether or not they reneged depended on the presence or absence of a compliance system. Economists would predict that the presence of a possible fine should cause one of two things to occur: (1) there would be zero change in behavior (that is, manufacturers would not run their scrubbers) because the fine was so negligible that it would have no impact, or (2) because the fine made reneging less attractive, there would be greater adherence and more scrubbers running. In Ann and David's study, something very different occurred. Although the presence of a fine made reneging less attractive from a financial perspective, it actually led to *more* reneging, not less. When there was no compliance system, more than half of participants stuck by the promise and agreed to run their scrubbers. In the presence of a compliance system, however, less than half of participants stuck to the agreement; a majority reneged on the original commitment.

Ann and David traced their results to the lens through which the participants viewed the decision. When no compliance system was in place, most saw the decision as an ethical one. In this case, individuals appeared to be searching for an answer to the question, "What is the right thing to do?" By contrast, when a compliance system was in place, most participants believed they were making a business decision. In this case, they appeared to ask themselves this question instead: "What is the likelihood I will get caught, and how much will it cost me?" The imposition of a compliance system led to ethical fading, such that participants were less likely to see the decision as an ethical one and therefore more likely to renege on the promise.

To see how this phenomenon plays out in other realms, consider the case of a day-care center frustrated by parents who arrived late to pick up their children.¹⁸ In an attempt to curb such late pickups, the center began requiring parents to pay a fine every time they picked up their children after hours. Problem solved? Not at all. In fact, more children were picked up late *after* the fine was instituted. Rather than decreasing undesirable behavior, the fine increased it. Why? Because the day-care center failed to account for the decision process of an individual faced with a fine. Suddenly, the ethical dimension of the problem was removed from parents' decision-making process. No longer did they view picking up their kids on time as the "right" thing to do. The fine caused them to focus their decision on the question of time versus

money. In effect, late pickup became just another service being offered by the day-care center.

Note that in each of these contexts, the compliance system was a weak one without much teeth. The manufacturers could afford to pay the small fine, as could the parents who chose to stay a little longer at the office. A logical question would be whether it's only such weak compliance systems that exacerbate unethical behavior. In terms of our study, if the probability of getting caught were stronger and the fine were greater, participants would be less likely to renege on the agreement to run the scrubbers, right?

When we ran our study using a stronger compliance system, we did indeed find that renegeing decreased.¹⁹ However, we also discovered that, as in the case of the weak sanctioning system, most participants who were exposed to the strong sanctioning system saw it as a business decision, not an ethical one.

Why does it matter whether a compliance system leads to ethical fading if the desired results are achieved? The problem lies in what happens when the compliance system fails or is phased out. Returning to the day-care story, the center eventually removed the fine for late pickup; however, parents continued to pick up their kids late more often than they did before the fine was put into place. We've already seen that compliance systems tend to transform ethical decisions into business or practical decisions involving a calculation of the costs and benefits of compliance. This perspective remains even after the compliance system is removed. When a strong compliance system is dismantled, the costs of noncompliance become less onerous; the ethics have been faded from the decision, and the decision remains a practical one, with deviant behavior an attractive option.

Not only can compliance systems fail on their own, but individuals subjected to compliance systems often find ways to bring these systems down. Consider the phenomenon of "psychological reactance," or the common tendency to rebel against constraints on one's freedom. Psychologists have found that efforts to direct individuals' behavior often fail because individuals will devote extra effort to reclaiming their threatened freedom.²⁰ Forbidden fruit—whether video game privileges for children or a romantic interest who plays "hard to get"—becomes even more attractive when it's off limits. Compliance systems can have the same effect. When employees feel overly controlled, noncompliance may become more attractive simply because it's forbidden. To break free of the constraints created by compliance, employees may attempt to weaken, bypass, or trick the compliance system, determined to beat it at any cost.

While compliance systems can work, their failure rate is surprisingly high, often at great expense to employers. But the primary danger of compliance systems lies in their contortion of the decision-making process. Suddenly, instead of thinking about doing the right thing, employees focus on calculating the costs and benefits of compliance versus noncompliance—and about trying to outsmart the system.

How can an organization effectively head off unethical behavior rather than exacerbate it? As we will discuss, an examination of an organization's informal values through the lens of behavioral ethics will help to determine when compliance systems will work. Managers also need to guard against the trap of "forcing" ethics through monitoring, surveillance, and

sanctioning systems. Promoting frameworks that highlight the ethical rather than the compliance dimensions of a decision will help ensure that employees are always cognizant of the ethical dimensions of any decision. In addition, leaders should encourage their staff to ask this important question when considering various options: "What ethical implications might arise from this decision?"

When Doing Good Becomes a License to Misbehave

We are aware of a number of not-for-profit organizations that are working hard to make the world a better place, yet mislead their constituencies about their success. They selectively provide data that make their organizations look better than reality suggests, and even manipulate data before releasing it to the public. These organizations are run by good people who likely would not mislead the public in a similar manner if they were running for-profit corporations. For example, they cannot be compared to cigarette industry executives who intentionally ran disinformation campaigns to confuse the public about the hazards of smoking. Rather, their focus on the good work they achieve appears to provide these leaders with an excuse to engage in dishonesty with the goal of raising more funds for their good causes. In [Chapter 1](#), we described an experimental study in which individuals had an opportunity to earn more money for themselves by cheating on the math puzzles they had been assigned to complete. Current research suggests that people are more likely to cheat on these tasks if they are earning money for charity than if they are earning money for themselves.²¹

Similarly, behavioral ethics research in the areas of moral compensation and moral equilibrium suggests that organizational efforts to promote ethical behavior can actually be associated with an *increase* in unethical behavior.²² According to these theories, we each maintain a moral identity that we keep in balance by engaging in minor, compensatory moral behaviors. Because our moral behavior is dynamic, when we engage in a moral act, we may feel licensed to engage in immoral behavior in the future. Conversely, when we behave unethically, we may be motivated to behave more ethically in the future. For example, it has been found that reminding people of their humanitarian traits leads to subsequent reductions in charitable donations.²³ By contrast, when individuals violate their moral values, they are more likely to comply with requests for help.²⁴ Recent research conducted by Ann and her colleagues provides further evidence of this effect. In the study, some participants were asked to recall items that elicited a more positive moral self-image, such as the many things they did to contribute to environmental preservation or the few things they did to contribute to environmental destruction. These participants were significantly less likely to support programs to offset carbon dioxide emissions than were participants who were asked to recall items that elicited a less positive moral self-image (i.e., the many things they did to contribute to environmental destruction or the few things they did to contribute to environmental preservation).²⁵

This finding relates to the example of disclosure of conflicts of interest. In [Chapter 5](#), we discussed the problem of conflicts of interest that arise when advisers, such as auditors, have misaligned incentives that cause them to condone unethical behavior or act unethically themselves. When scandals surrounding conflicts of interest arise, organizations, industries, or the government often respond by instating disclosure requirements that compel advisers to reveal the nature of their conflict of interest to their clients. The Sarbanes-Oxley Act, which requires corporations and the auditors that serve them to disclose their conflicts of interest, has been heralded as a means of achieving the goal of transparency and making companies more honest. Most people like the idea of requiring greater openness while still allowing professionals to act as they see fit. The well-intentioned focus on disclosure is based on the assumption that the public will benefit from increased information about an adviser's conflict of interest.

Unfortunately, disclosure isn't a fail-proof panacea for curbing unethical behavior. Not only do disclosure requirements fail to achieve their assumed objectives, they can actually have perverse effects on ethical behavior.²⁶ One interesting experiment reveals why. In the experiment, some participants, "the estimators," were asked to estimate the number of coins in a jar; other participants, "the advisers," were asked to advise the estimators as to the value of coins in the jar. The advisers were allowed to look more closely at the jar than estimators could. Estimators were paid according to the accuracy of their estimates. Some of the advisers were paid based on the accuracy of their estimator's estimate (after receiving the adviser's advice). Other advisers were paid based on how *high* their estimator's estimate was. Advisers in this condition faced a conflict of interest, as they would be rewarded not for their accuracy, but for estimate inflation. Not surprisingly, this latter group of advisers delivered higher estimates to their estimators than did the advisers who did not face a conflict of interest. More interesting, for our purposes, was what happened when the advisers disclosed their conflict of interest to their estimators: These advisers' estimates were higher and less accurate than those of other advisers; moreover, the estimators didn't discount the advice after learning of the conflict of interest. As a result, advisers actually earned more money, and estimators earned less money, when this conflict of interest was disclosed to estimators. In other words, disclosure actually *increased* the ill effects of the conflict of interest.

The goal of transparency is a rational one, yet it results in unintended consequences when we fail to account for the psychological process of moral compensation. In the study we've just described, disclosure apparently gave advisers a psychological license to severely overestimate the value of the coins. The opportunity to behave morally by disclosing a conflict of interest seems to give people a license to engage in future immoral behavior (inflated estimates, in this case) and therefore to maintain their moral equilibrium.

Managers and other decision makers can mitigate the deleterious effects of moral compensation through the separation of ethical and unethical standards, a zero-tolerance policy for unethical behavior, and standards for ethical behavior that are continually adjusted upward. Moral compensation is significantly less likely when leaders communicate to employees that unethical behavior is distinct and separate from ethical behavior and when they set a separate

standard for the two. For example, setting a zero-tolerance standard for unethical behavior, while at the same time setting standards for honest reporting, makes it more difficult for employees to attempt to mitigate unethical behavior through good deeds. Similarly, by continually raising the bar for ethical behavior, organizations make it more difficult for employees to settle in on a comfortable “ethical balance.”

The Domination of Informal Cultures

In the 1980s, Ann’s father worked on the management side of management-union negotiations in the wholesale food industry. He would come home with colorful stories of the negotiations, describing in particular how union leaders would grandstand in front of their constituents, promising to fight management on any and all concessions and bring home a victory. Management, he admitted, would present an equally tough stance, steadfast about the need for concessions and their ability to fight to the bitter end. Behind closed doors, however, the theatrics ended. Union and management representatives would turn to each other and politely ask, “What will it take to settle this?”

As this anecdote illustrates, organizations’ public, formal norms are often at odds with the informal, often hidden cultures that guide employees’ behavior. Like formal policies and communications, informal organizational cultures send signals regarding acceptable behavior, including ethical behavior.²⁷ Formal ethics programs, such as codes of conduct, ethics training, and mission statements, tend to be well documented. By contrast, the signals conveyed through informal cultures do not come from official pronouncements or actions; rather, they are “felt” by organizational members.²⁸ Carrying messages that are heard but not seen, informal cultures represent the unofficial messages regarding ethical norms within the organization. It is through informal mechanisms that employees learn the “true values” of the organization.

Consider the case of an actual company that had a formal code of conduct that exhaustively described the ethical standards that its employees were expected to meet. The code of conduct was deemed so important that all employees were instructed to read the manual and then sign a “Certificate of Compliance” form. That should do the trick, right? Unfortunately, at Enron, it did not.

Like Enron, Johnson & Johnson has well-established codes of conduct (see figures 7 and 8).²⁹ Why, then, have we witnessed such dramatic differences between these two companies in terms of ethical behavior? Differences in the length and content of the two documents are probably not to blame. More likely, the real difference can be traced to the informal cultures in which these formal systems were embedded. Johnson & Johnson is widely known for its ethical culture, the best-known example being the company’s voluntary recall of Tylenol during the 1982 cyanide-tainting crisis, a decision estimated to have cost the company \$100 million.³⁰ In this company, its formal code of ethics was consistent with its informal culture. (Some would argue that a recall of numerous Johnson & Johnson medicines in 2010 suggests that this informal culture has lapsed, despite the continued existence of the credo.) By contrast, Enron

became notorious for its underlying culture of greed and competition. The company's sophisticated, lengthy formal code of conduct was no match for its unethical informal culture.

Ann and her colleagues Kristin Smith-Crowe and Elizabeth Umphress argue that formal systems are the weakest link in an organization's ethical infrastructure and are typically far eclipsed by their informal counterparts.³¹ Ralph Larsen, the former CEO of Johnson & Johnson, expressed a similar opinion when he told the *National Journal*, "All the laws in the world cannot ensure that corporate executives will observe them day in and day out."³² Indeed, one study of employee deviance in the retail, health care, and manufacturing industries found that the formal controls of managers were inferior to the informal social controls imposed by coworkers.³³ Anthropologists argue that such informal systems can be traced to our evolved mental capacity for social organization; by contrast, because formal systems have no evolutionary roots, they are artificial and less influential.³⁴ In groups, informal norms have been identified as the initial forces that guide transactions and other activity. Only as groups grow larger and more diverse do formal mechanisms (such as contracts and codes of conduct) emerge to facilitate their activities.³⁵

Sometimes formal systems are weak because they were purposefully designed to be that way. Specifically decoupled from the organization's "true" inner workings, codes of conduct can be mere attempts to convince outsiders, and particularly investors, that the organization is ethical while disguising its more important goals, such as profit maximization. Research on annual reports offers some support for this perception. Firms that use ethics-related terms such as "ethics" and "corporate responsibility" in their 10-K annual reports are more likely to be associated with "sin" stocks, or publicly traded companies involved in producing alcohol, tobacco, and gaming. Notably, firms using ethics-related terms in these reports are also more likely than other firms to be the object of class-action lawsuits and to score poorly on corporate governance measures.³⁶ Apparently, companies in need of a good disguise rely on "ethics marketing" in their annual reports.

If a corporation were truly concerned about its ethics, would it carefully craft compliance systems and codes of ethics designed to address its unique structure and problems, or would it simply borrow the systems and codes of another organization? Interestingly, plagiarism of an ethics code could be a sign that an organization's ethical aspirations may be nothing more than window dressing. One study that compared corporate codes of ethics found substantial levels of similarity in sentences and content.³⁷ In a sample of the Standard & Poor's 500 Index, the average firm had about 37 sentences in its code of ethics that were repeated word for word in other S&P 500 codes. For some codes, the overlap was 222 sentence matches! One of the most common sentences—"Theft, carelessness and waste have a direct impact on the company's profitability"—was traced to an identical sentence in a New York Stock Exchange regulatory document that specifies the topics a company's codes should address. Worse yet, there were some cases of complete ethics code duplication. Formal systems that are borrowed from another firm, rather than reflecting the specific values of an organization, are a shallow overlay with relatively little impact.

Our Credo

We believe our first responsibility is to the doctors, nurses and patients, to mothers and fathers and all others who use our products and services. In meeting their needs everything we do must be of high quality. We must constantly strive to reduce our costs in order to maintain reasonable prices. Customers' orders must be serviced promptly and accurately. Our suppliers and distributors must have an opportunity to make a fair profit.

We are responsible to our employees, the men and women who work with us throughout the world. Everyone must be considered as an individual. We must respect their dignity and recognize their merit. They must have a sense of security in their jobs. Compensation must be fair and adequate, and working conditions clean, orderly and safe. We must be mindful of ways to help our employees fulfill their family responsibilities. Employees must feel free to make suggestions and complaints. There must be equal opportunity for employment, development and advancement for those qualified. We must provide competent management, and their actions must be just and ethical.

We are responsible to the communities in which we live and work and to the world community as well. We must be good citizens—support good works and charities and bear our fair share of taxes. We must encourage civic improvements and better health and education. We must maintain good order the property we are privileged to use, protecting the environment and natural resources.

Our final responsibility is to our stockholders. Business must make a sound profit. We must experiment with new ideas. Research must be carried on, innovative programs developed and mistakes paid for. New equipment must be purchased, new facilities provided and new products launched. Reserves must be created to provide for adverse times. When we operate according to these principles, the stockholders should realize a fair return.

Johnson & Johnson

Figure 7. Johnson & Johnson Credo. Reprinted with permission from Johnson & Johnson.

Business Ethics

Employees of Enron Corp., its subsidiaries, and its affiliated companies (collectively the "Company") are charged with conducting their business affairs in accordance with the highest ethical standards. An employee shall not conduct himself or herself in a manner which directly or indirectly would be detrimental to the best interests of the Company or in a manner which

would bring to the employee financial gain separately derived as a direct consequence of his or her employment with the Company. Moral as well as legal obligations will be fulfilled openly, promptly, and in a manner which will reflect pride on the Company's name.

Products and services of the Company will be of the highest quality and as represented. Advertising and promotion will be truthful, not exaggerated or misleading.

Agreements, whether contractual or verbal, will be honored. No bribes, bonuses, kickbacks, lavish entertainment, or gifts will be given or received in exchange for special position, price, or privilege.

Employees will maintain the confidentiality of the Company's sensitive or proprietary information and will not use such information for their personal benefit.

Employees shall refrain, both during and after their employment, from publishing any oral or written statements about the Company or any of its' officers, employees, agents, or representatives that are slanderous, libelous, or defamatory; or that disclose private or confidential information about their business affairs; or that constitute an intrusion into their seclusion or private lives; or that give rise to unreasonable publicity about their private lives; or that place them in a false light before the public; or that constitute a misappropriation of their name or likeness.

Relations with the Company's many publics—customers, stockholders, governments, employees, suppliers, press, and bankers—will be conducted in honesty, candor, and fairness.

Figure 8. Enron code of ethics. Courtesy of the Department of Justice. <http://www.justice.gov/enron/exhibit/02-06/BBC-0001/Images/EXH012-02970.PDF>

Oftentimes, formal compliance programs are weak not because of flaws in their design, but because they are overshadowed by the organization's informal culture. The power of informal cultures to trump formal systems is clearly illustrated in the demise of Enron and Arthur Andersen. In what one observer described as a "quiet dilution of standards and the rise of auditor-salesman," "bluntly honest" auditors within Andersen, particularly those associated with the firm's Professional Standards Group (the "watchdog group" designed to keep its audits honest) were belittled and denigrated, such that they took on second-class status.³⁸ When a former partner of Andersen's Ethics and Responsibilities Business Practices consulting services brought up the subject of internal ethics, she said she "was looked at as if [she] had teleported in from another world."³⁹

At the headquarters of Enron, Arthur Andersen's most powerful client, a similar story

unfolded. CEO Kenneth Lay made it clear that informal rules trumped formal codes of conduct, wrote reporter Alexei Barrionuevo in the *New York Times*:

Ethical rules that he had helped set up at Enron, including the company code of conduct, somehow did not apply to him, Mr. Lay suggested. When questioned . . . about a \$160,000 personal investment he made in a photo-sharing company that did more than 80 percent of its business with Enron, Mr. Lay called suggestions of impropriety “form over substance.” Rules, he said, “are important, but you should not be a slave to rules, either.”⁴⁰

In contrast to formal norms and rules, informal norms are difficult to overtly identify. Rather, they are embedded in the stories employees tell, the euphemisms they use, the socialization methods they encounter, and the informal enforcement of norms. Consider Ann’s experience as a new professor at Notre Dame University. When she was moving into her office, numerous students offered to help her with her boxes. She politely declined their kind offers, but the students were so insistent that she finally acquiesced. The students not only opened doors for her, but carried boxes to her office and then followed her to her car to see if they could help with more. Ann appreciated the generosity of this assistance, but couldn’t help but wonder if it was motivated by the fact that she is a short woman and was clearly struggling with the boxes.

About two years later, Ann heard a colleague in her department describe the move-in experience of another colleague—a man who was anything but short and appeared to be quite strong. Just like Ann, the male colleague reportedly had been amazed by the offers of help. Later, Ann jokingly accused her colleague of stealing “her” box story, only to learn that he truly had experienced the same generosity. Together, these stories powerfully reveal the informal values that characterize Notre Dame. “Help professors carry boxes” cannot be found in any student handbook; rather, these norms are made visible and salient through stories repeated in informal conversations.

Informal norms don’t even require a complete story to become ingrained in an organization or society. The words we choose to describe, or disguise, behaviors can be just as effective. In his sketch “They’re Only Words,” the comedian George Carlin traces the evolution of the term used to describe the effects of battle stress on soldiers.⁴¹ Labeled “shell shock” in World War I, the term became “battle fatigue” in World War II, only to morph into “operational exhaustion” in the Korean War, and finally “post-traumatic stress disorder” (or PTSD, for short) during the Vietnam War. Through humor, Carlin argues that as the term has been sanitized over time, it has buried soldiers’ pain under jargon and made it easy for society to ignore the issue.

In a similar manner, organizations attempt to mask their unethical behavior by cloaking it in innocuous language. “Collateral damage” is more acceptable than “dead civilians,” and “earnings management” and “creative accounting” are less bothersome terms than “cooking the books.” Nuclear radiation is measured by “sunshine units,” pollution becomes “runoff,” and chemical waste is “by-product.” Employees are “laid off,” “downsized,” and “made redundant,” but they are rarely fired. Disguising the brutality of harmful behavior with soft language makes the unacceptable permissible and allows unethical practices to abound. In

addition to perpetuating unethical behavior, euphemisms send a powerful informal signal about an organization's values to its employees: As long as you disguise and hide your unethical behavior, we will accept it, and indeed even encourage it.

In addition to absorbing informal norms through stories and euphemisms, we pick up on them by observing which behaviors are rewarded and which are not. A lawyer in a prestigious law firm told the story of a group of junior associates who were having dinner together. The group included three junior associates who were performing up to expectations and another junior associate who was the firm's "golden boy"—a star performer who was getting choice assignments and working with the best partners in the firm. Junior associates, like all members of law firms, have to bill their hours in increments and assign them to specific billing codes. As we have noted, because the list of codes can be exhaustive, accurately accounting for one's time in such detail is often difficult, requiring lawyers to keep copious notes and constantly record their hours on their time sheets. During dinner, as the moderately performing associates were discussing the time-consuming nature of the billing process, the star associate pulled out his timesheet and quickly filled it in for several weeks, without referring to any notes on how he had spent his time. It was obvious to the other associates that this star's reporting wasn't particularly accurate or truthful. Formal policies clearly specified accurate billing procedures, and the list of billing codes had been carefully reviewed with the associates. Yet the cavalier actions of the star left these formal rules in the dust.

Like formal rules, informal norms are reinforced not only with rewards but also with sanctions, often with much more alarming results.

Take one of the world's largest makers of cast-iron water and sewer pipes, McWane. The company's informal sanctions are seen as incredibly influential and largely responsible for the company's reputation as "one of the most dangerous businesses in America."⁴² In 2003, in an industry that had the worst safety record, McWane held the title for the highest employee injury rate, and with good reason: between 1995 and 2003, McWane had been cited for more than 400 safety violations, four times more than its six major competitors combined. Having been found in violation of pollution rules and emission limits at least 450 times during that same time period, McWane plants also have been identified as among the worst polluters in New Jersey, Alabama, and Texas. Supervisors are said to routinely ignore safety and environmental laws that conflict with production, going so far as to dump polluted water in the dark of night. Informal sanctions within the company reportedly allow these practices to perpetuate. Workers who protest working conditions are "bull's-eyed," or marked for termination. Injured workers are bullied, and union leaders are intimidated.

The following anecdote, reported in the *Chicago Tribune*, reveals that the enforcement of informal norms—in this case, the norm that stealing is to be tolerated—can be quite extreme in organizations:

The voice on the police line was firm but halting: "OK. I'd like to report an employee theft which is gonna occur at James River [paper mill] . . . I witnessed ah, him, you know,

loading the stuff up . . . to take it out . . . but, he ah, ah, he's known to be violent." After a five-day suspension for refusing to cooperate with an investigation of the reported theft, the [accused] employee, Keith Kutska, legally acquired a recording of the call. Then he took it to work, "because people wanted to know who the snitch was," he said at a hearing. "I played it and said, 'There he is.'" One day later, on November 22, Monfil's [the accuser's] body was found at the bottom of a 20-foot holding vat for tissue pulp. A jump rope attached to a 40-pound weight was tied to his neck.⁴³

The influence of informal systems within organizations is not lost on Hector Sants, the chief executive of Britain's financial industry regulatory body, the Financial Services Authority (FSA). In the wake of the 2008 financial crisis, interviewees for senior banking jobs with the FSA are now being subjected to a much stricter interview process, one that includes an assessment of their ability to foster an ethical culture. Executives are evaluated based on how they treat customers and their ethical behavior in the marketplace. "Our aim would therefore be to seek to facilitate the creation of good cultures and intervene when bad ones seem to be creating unacceptable outcomes," Sants told the *New York Times*.⁴⁴

This practice suggests a potentially useful means of improving the ethicality of informal cultures within organizations. Leaders should inventory the informal systems that exist and work to understand the underlying pressures that are put on employees. Such pressure points can come from existing reward systems, from other employees, and from supervisors. By focusing on the underlying cultures that may counteract formal systems, leaders may be able to make strides toward creating positive informal cultures that reinforce ethical behavior and shun unethical behavior.

Although organizational efforts to create systems that improve members' ethical behavior are often well intentioned, psychological processes limit the effectiveness of such solutions. Unless leaders take individuals' actual decision processes into account, employees and citizens in general will largely ignore these systems or even increase their unethical behavior. In table 1, we summarize the barriers presented in this chapter and describe possible steps you and your organization can take to cope with them. Designing effective systems to promote ethical behavior in organizations requires an understanding of the obstacles that are likely to arise and a set of strategies to overcome them.

Designing Effective Systems to Promote Ethical Behavior in Organizations

Barriers	What problems can arise?	Issues to consider
Reward systems	Reward systems don't consider the means to which people may go to achieve the goals or the potential impact on other goals.	When setting goals, brainstorm all of the side-effects of achieving the stated goal. Involve those who are actually being rewarded and ask them to identify the likely behaviors that will result.
Sanctioning systems	Punishing unacceptable behavior encourages ethical fading and increases the probability that the behavior will be evaluated via a cost-benefit	Include ethical assessments when making decisions related to personnel, strategy, or operations. Make sure that the question "What ethical implications might arise from this

analysis rather than on its ethicality.

decision?" is asked routinely when considering various options.

Moral compensation

Ethical acts can be used as justification for unacceptable behavior in another domain.

Have separate standards for ethical and unethical behavior. Set a zero-tolerance policy for unethical behavior. Set high expectations for ethical behavior and stress the importance of continually raising ethical standards.

Informal systems

Informal cultures and peer pressure can dominate well-intended formal ethics systems.

Inventory the organization's informal systems and work to understand the underlying pressures on employees. Strive to create positive informal cultures that reinforce ethical behavior and shun unethical behavior.