Social norms for ethical behavior in business settings

1. Introduction

In most economic models of organization, individuals’ behaviors are guided by contractual, legal, and reputational considerations. With respect to many choices that individuals face, however, another factor also guides their behavior, namely, a desire to adhere to some standard of conduct or social norm. This note provides an overview of some academic research on social norms and relates this research to business practices.

2. Research

Social psychology research on ethical behavior; economic research on corporate culture, performance reporting, and agency; and experimental and field study research regarding ethical behavior all bear on the issue of organizational norms. Findings from each of these areas are discussed below.

2.1 Psychological and Sociological Perspectives

Kohlberg (1984) orders moral development along a continuum containing three principal segments or levels: pre-conventional, conventional, and post-conventional. He argues that individuals may progress from one level to another as they mature.  

Reminiscent of agents in traditional economic agency models, the pre-conventional individual responds to rewards and penalties associated with legal and reputation concerns. Conventional individuals differ from the pre-conventional in that they exhibit a desire to respect norms of behavior. A prominent feature of conventional individuals is that their judgements are influenced by their beliefs about the judgements their peers would make in

---

1 Moral development typically is measured by a psychometric questionnaire such as the Defining Issues Test (DIT). Rest et al. (1999) survey over 400 published studies and report that much of the variation in DIT scores is attributable to education. DIT scores also increase with age. Many studies support the notion that moral development proceeds in stages that are invariant across cultures and that moral development continues into the third decade of life. See, e.g., chapters 8 and 9 of Kohlberg (1984) for longitudinal evidence gathered from a Turkish village and city, and an Israeli kibbutz.
the same circumstances. In turn, these judgements are related to individuals’ actions.\footnote{Blasi (1980) concludes that most studies show a correlation between an individual’s level of moral development and the actions he takes.} Finally, agents are influenced by personal norms of behavior that are not a function of the actions of other agents in the organization. Post-conventional agents are most influenced by this type of norm. Post-conventional individuals are less susceptible to peer influences and more inclined to behave according to theories of justice and rights.\footnote{Whistle blowers and conscientious objectors are often identified as post-conventional. A related notion in psychology is locus of control, which is often measured using a personality test developed by Rotter (1966). Rotter found strong support for the hypothesis that individuals who have an internal locus of control (i.e., those who believe they control their destinies) resist attempts by others to influence their behavior and are less likely to conform.}

Social norms are endogenous because they are determined by the choices of all the agents who are members of the organization. In turn, these choices are driven by the design of the organization (i.e., the types of agents the organization attracts and the contractual incentives provided to those agents).

The psychological evidence is that, in the main, professional organizations of educated adults contain a majority of conventional types, a minority of post-conventional types, and few pre-conventional types.

### 2.2 Related economic models

The importance of social norms has long been recognized by economists. For example, Adam Smith (1789) acknowledges the role of conscience as an important contributor to a well-functioning economic system. Arrow (1974) asserts that values such as trust, loyalty and truth-telling have important economic value.

In a survey of work in economics on norms, Hart (2001) considers how norms for cooperation and trust may be interpreted as emerging from threats of grim punishment strategies in infinitely repeated games, asymmetric information about player types when players may be irrational in finitely-repeated games, and situations where agents incur a psychic cost from breaking a promise. He concludes that there is a need for a better theory of norms within organizations and issues the challenge: “[W]ould a theory of incentives or organizations that incorporated norms look very different from the standard theory?”

Koford and Penno (1992) consider how accounting system choice changes when it is assumed that agents may be one of two types, self-interested or
truth-teller. Since someone who does not lie will always respond truthfully to the questions “Did you steal?” and “Did you shirk?”, truth-telling rules out moral hazard. Koford and Penno show that investment in internal control decreases when a higher fraction of agents are ethical, and point to the complexities that arise when agents self-select into organizations and organizations may attempt to screen agents.

Kreps (1997) provides a taxonomy of economic explanations for adherence to social norms: (i) it is less costly than deviating, (ii) it facilitates coordination, (iii) it is costly but leads to better treatment by others, and (iv) it is desirable per se. As an example of (i), social sanctions may deter eating with one’s fingers at the table. As an example of (ii), Kreps (1990) suggests corporate culture can make one equilibrium focal when there are many possible equilibria. As well, corporate culture enables one party to predict how others will respond to novel situations. As an example of (iii), corporate culture, which may be conceived of as a reputation for responding to contingencies in consistent ways, has value because it permits the transactions costs of specifying and enforcing contractual terms to be reduced or avoided.

Fehr and Falk (2002) distinguish between two human social desires that interact with economic incentives: the desire to reciprocate—see, e.g., Bolton and Ockenfels (2000) and Charness and Rabin (2000), who examine how notions of equity and fairness influence behaviors—and the desire for social approval. Models of reciprocation incorporate interdependent preferences (i.e., agents exhibit concerns about their own payoffs and the payoffs received by others), but do not address social norms with respect to unobservable acts, including endogenous norms driven by moral reasoning.

As an example of the social approval literature, Fischer and Huddart (2004) suppose agents are influenced by a group or social norm of behavior established implicitly through the behavior of others in the same organization: an agent is more willing to engage in the undesirable act if others engage in that act.

2.3 Laboratory Experiment and Field Study Evidence

Accounting researchers also have conducted laboratory experiments and field studies examining how an individual’s level of moral development and peer group interact with the reporting choices the individual makes. The evidence from these studies supports three important features of behavior in business settings: (i) individuals are of different types and one’s type affects
one’s decisions, (ii) social norms influence decisions, and (iii) organizations select employees of particular types. First, Arnold and Ponemon (1991) find that internal auditors with high moral development (as determined by responses to a psychometric questionnaire) are more likely than those with low moral development to suggest whistle blowing. This is evidence that individual types vary and that type matters to decisions. Second, Ponemon (1992b) finds that peer pressure increases the likelihood that audit staffers will mis-report the time spent on an audit task. Relatedly, Lord and DeZoort (2001) find that peer pressure increases the likelihood that auditors sign off on financial statements that are materially misstated. In turn, these two articles suggest that both innate aversions and social norms influence behavior in an economically significant fashion. Third, Ponemon (1992a) finds that public accounting firms select and promote individuals who demonstrate a low but homogenous level of moral development. This is evidence that organizations function in ways that attract types with particular traits, and suggests that social surplus is determined, in part, by organizational boundaries.

3. Implications for organizational design

Norms plausibly influence the optimal design of an organization. If the choices of one group of employees affect the social norm for the entire peer group, then incentive contracts offered to one group of agents to induce particular action choices also affect the action choices of conventional agents elsewhere in the same organization. For example, increasing the power of incentives provided to one group of employees to elicit a higher supply of the desirable action also induces some additional undesirable activity from those employees. In turn, this increase in undesirable activity adversely influences the behavior of the other employees in the organization.

Since the boundaries of an organization define the peer group to which the social norm applies, the spillover effects from incentive contracts can influence the optimal boundaries of the organization. Fischer and Huddart (2008) provide conditions under which it is better to split up a diverse organization employing high-powered incentives for one group and low-powered incentives for another into two separate organizations because the behavior of the group facing high-powered incentives adversely affects the behavior of others within the same organization.

Taking as given that individuals differ with respect to how their behavior is affected by personal and social norms, Fischer and Huddart (2008) analyze issues related to the matching of agent types with tasks. Under
the reasonable assumption that traits are difficult to observe, Fischer and Huddart predict that organizations employing high-powered incentives to induce high levels of desirable actions are more likely to employ more conventional agents (i.e., agents who are more influenced by the behavior of others around them).

Fischer and Huddart also consider the implications of norms that influence desirable actions, rather than undesirable actions. In this case, increases in the power of individual incentives reinforce, rather than erode, the norm. Further, the optimal matching of agent types to organizations naturally arises, whereas the optimal matching of types to organizations and tasks is difficult or impossible to achieve when norms affect the undesirable action.

4. Applications

The considerations can be applied in a variety of setting, including: (i) financial reporting choices of managers, (ii) the professional judgements of external auditors, (iv) individuals’ internet file sharing activities, and (iv) aggressive corporate tax planning within certain corporations.

4.1 Performance measure manipulation

Performance measure manipulation (i.e., earnings management) is one area where social norms seem relevant. With respect to managerial reporting behavior, the undesirable action can be interpreted as costly actions that inflate near-term earnings. Examples of such actions include offering excessive discounts in one period (thereby cannibalizing sales in the next), or incurring tax and transactions costs associated with financial transactions that increase accounting earnings without adding economic value. High-powered incentives within any significant unit of organization adversely affect the norms of managerial reporting behavior across the organization. Furthermore, firms with higher-powered incentives will generally attract conventional, as opposed to post-conventional, managers. These individuals are influenced more by the social norm, so the problem of earnings manipulation is exacerbated.

For empirical evidence that some managers sacrifice real resources to inflate earnings, see Erickson, Hanlon, and Maydew (2004) and Oyer (1998). There is also evidence that (i) people differ in their responses to the ethical dilemmas posed by financial reporting, and (ii) people of similar moral
development cluster within particular professions and organizations. In a survey of managers from many different corporations, Bruns and Merchant (1990) document a wide range of attitudes towards various types of earnings management (i.e., making operational decisions, timing the recognition of non-operational transactions, or choosing accounting methods so as to manipulate reported earnings). Poneman and Gabhart (1994) survey the evidence that the degree to which individuals, on average, are conventional varies across professions, and personnel selection and promotion reduce the variation in type within public accounting firms, especially among more senior members of the firm. In a related vein, Slemrod (2004) points out that corporations differ in the aggressiveness with which they undertake abusive tax avoidance strategies, and suggests that the cause of the variation has an ethical dimension.

4.2 Public accounting

An analysis of culture clash within an organization is particularly relevant to the auditing industry. With respect to auditors’ judgements, the undesirable action may be thought of as an audit partner’s ready assent to accounting methods and disclosures advocated by a client’s managers, but of dubious propriety. Such assent may increase the probability of receiving supplementary fee revenue from the client (for, e.g., non-audit consulting engagements) that will be credited to the audit partner in the audit firm’s internal performance reports and profit sharing scheme, but assent to dubious accounting can have serious detrimental consequences to the audit firm. Whether external auditors appease clients to secure additional revenue from those clients is a contentious issue among both public accountants and academics. Frankel et al. (2002) find that non-audit fees are positively associated with small positive earnings surprises, the magnitude of absolute discretionary accruals, and the magnitude of income-increasing and income-decreasing discretionary accruals. These associations are consistent with the appeasement hypothesis.

A debate is ongoing about the propriety of auditing firms providing non-audit, primarily consulting, services to audit clients. Fischer and Huddart (2008) show how combining such activities can be costly. Suppose

---

4 For an anecdotal account of the varied responses of lower-level managers to top-level managers’ adoption of accounting treatments that violate generally accepted accounting principles, see Susan Pulliam and Deborah Solomon (October 30, 2002) “Uncooking the Books: How Three Unlikely Sleuths Discovered Fraud at WorldCom” Wall Street Journal.
consultants have greater incentives to assent to client management positions on consulting issues. Given these incentives, if consultants join accounting firms, then the actions of the consultants influence the auditors so that auditors are more willing to assent to management positions on accounting issues.

Some have claimed that the significant increase in the provision of non-audit services by public accounting firms over the past two decades has eroded the culture of independence within those firms’ audit practices. For instance, Arthur R. Wyatt (former partner and managing director of accounting principles of Arthur Andersen, former U.S. representative and chair of the International Accounting Standards Committee, and former Financial Accounting Standards Board member) describes changes in the culture of Arthur Andersen, a defunct but formerly prominent accounting and consulting firm, brought about by the admission to partnership of consultants who did not possess a professional background in accounting:\(^5\)

\(^5\) See, also, the comments of Arthur Levitt (2000), a former Securities and Exchange Commission Chairman; and the General Accounting Office’s investigation of the public accounting firms mandated by the Sarbanes–Oxley Act (GAO, 2003).
In essence, the culture of the leading firms in the profession had changed. The infusion of new personnel, some at relatively high levels, who lacked a background that placed prominence on accounting professionalism gradually gained increasing influence in accounting firms. . . . Staff personnel within the firms were easily able to observe the attributes of those who were the rapidly rising stars and undertook efforts to emulate these attributes. . . . Keeping the client happy and doing what was necessary to retain the client achieved a prominence that did not exist prior to the advent of the successful consulting arms with the firms. The core value of the professional firm were undermined by primarily commercial interests. . . . The issue was how the increasing infusion of personnel not conversant with, or even appreciative of, the vital importance of delivering quality accounting and audit service affected the internal firm culture, its top level decisions and behavior patterns of impressionable staff personnel. It wasn’t that consulting personnel were unprofessional in performing their work, but their actions and behavior were far more commercially driven than were auditor actions. A focus on investor or creditor interests did not exist, and their attitudes gradually affected how auditors approached their work. Auditors were more willing to take on additional risk in order to maintain their revenue levels. . . . Clients were more easily able to persuade engagement partners that their way of viewing a transaction was not only acceptable but also desirable. Audit partners too often acquiesced to the client views in the current period, agreeing to fix the problem next year. . . . The gradual changes in internal firm culture effectively altered the long-standing value systems of firm leaders, and the results have been costly and problematical of reversal. The cultural changes evolved over a long period and have become pervasive in nature. The current challenge of firm leaders has to be to gain an understanding of how the current culture evolved and how best to eliminate the damaging commercial initiatives and restore a proper, and expected, degree of professionalism. (Wyatt, 2003, pp. 17–19)
The spillover effects arising from combining audit and consulting services within the same organization may, in turn, make that organizational form suboptimal. Indeed, the perceived costs of combining these activities has led to the divestiture by most large accounting firms of most consulting practices, and a provision in the Sarbanes–Oxley Act of 2002 prohibiting the auditor of a public company from providing certain non-audit services to audit clients.

### 4.3 Internet file sharing

Social norm considerations are also important to understanding other issues of economic interest. For example, social norms are likely to be important to understanding how technological changes undermine legal systems and honor codes that are supported, in part, through social norms. For instance, the development of the internet and the digitization of copyrighted materials has facilitated the undesirable acts of copyright violation (e.g., music file sharing) and plagiarism not only by making such acts physically easier, but also by eroding the norms that discouraged such acts. Hence, further study of the economic implications of endogenous social norms is warranted.

### 4.4 Taxation

Another area where social norms have important economic effects is taxation. For fiscal policy to be effective, taxpayers must respond to the incentives in the tax code. Tax planning activities that reduce taxpayers’ tax payments and also further policy objectives are socially desirable. However, when the tax law prescribes large differences in tax payments across economic activities (e.g., development and manufacturing), entities (e.g., corporations or partnerships), time periods, or types of income (e.g., ordinary income and capital gains) to encourage certain activities, taxpayers may also engage in more abusive tax avoidance and evasion. The extent to which such undesirable activity takes place and is reinforced by taxpayers’ sense that other taxpayers also undertake these activities usefully may be examined from the social norms perspective presented in this paper.

### 4.5 Labor supply

Models where an endogenous disutility from violating a norm falls with the average level of violation in the population include Blomquist (1993), who examines the effect of taxes on labor supply, and Lindbeck et al. (1996), who examine the choice whether to work full time or not work at all and accept welfare payments.
5. Summary

An analysis of norms that discourage undesirable actions yields three insights:

- First, when agents with high-powered incentives are influential in setting social norms, splitting an organization into two independent organizations may be beneficial. Splitting the organization avoids the adverse impact the agents with high-powered incentives exert on the behavior of the organization’s other agents.

- Second, conventional agents (who are greatly influenced by the behavior of peers) may be of more or less value to the organization than post-conventional agents (who are less influenced by the behavior of peers). Conventional agents are preferred when incentives are low-powered because they are favorably influenced by the relatively good behavior of their peers. In contrast, conventional agents are detested when incentives are high-powered because they are adversely influenced by the relatively bad behavior of their peers.

- Third, if agents differ in their behavioral traits and these traits are unobservable, agents with the wrong traits will be attracted to organizations by contracts that are optimal for agents with the right traits. Specifically, conventional agents will be attracted to organizations with high-powered incentives and post-conventional agents will be attracted to organizations with low-powered incentives, although social welfare is greater if conventional and post-conventional agents’ organizational assignments are reversed.
References


