

## The Student Perspective

### Whistleblowers: Truth, Justice, and the American Way

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#### Executive Summary

This paper describes and discusses whistleblowing, examining the significant factors in the whistleblower's decision-making process and ethical reasoning. A discussion is presented on the current state of our corporate culture – fertile ground for whistleblowing. Focused on nongovernmental, external whistleblowing, this paper also describes the protections and administrative processes provided by Sarbanes-Oxley. Finally, this paper presents cases for discussion and offers several take-away ideas.

#### Introduction

Truth, Justice and the American Way. How else does one explain whistleblowing? The frenzy of Enron, the passage of Sarbanes-Oxley and, of course, *Time* magazine's naming of whistleblowers (Watkins, Cooper and Rowley) as its "Persons of the Year 2002," have created a new level of awareness, respect and even enthusiasm for whistleblowing. This new wave of consciousness has also created an opportunity, for both the employer and employee, to examine the reasoning, protections and risks of whistleblowing.

Driven by various motivations, whistleblowers have exposed dozens of foul companies over the last two years. As stated by Quarrels (2003, P. 7), however, "telling the truth in public is still a dangerous business." Past studies confirm that a whistleblower's life after whistleblowing can be a harrowing experience. For example, figures from 1991 denote that 90% of whistleblowers lost their jobs or were demoted; 26% sought medical care; 15% got divorced; 10% attempted suicide and 8% went bankrupt (Mead, 2002). A 1999 study, conducted by Rothschild and Miethe, denotes that 69% of whistleblowers lost their jobs or were forced to retire. In spite of the above, whistleblowing complaints have increased more than 200% since 1999 (Freed, 2003).

Whistleblowing is commonly perceived as both a positive and negative action. For example, a Time/CNN survey cited by Jennings (2003) indicates that 59% of respondents considered whistleblowers "heroes," yet 18% considered them "traitors." Regardless of one's view, whistleblowing is serious business. As discussed by Baynes (2002, P. 11), whistleblowers are in a position to "inflict harm on the corporation in a way that strangers cannot." Whistleblower actions can convert proprietary information, erode public image, subject the company and its management to civil or criminal sanctions and, worst case, result in corporate collapse. Whistleblowing reflects a failure in the subject corporate culture, an

unchecked wrongdoing. Significant to business is an employee's tendencies to blow-the-whistle: critical factors, ethical reasoning, options, and so forth. Of equal significance is the subject corporate culture and why it failed. An understanding of whistleblowing provides management with insight and direction when formulating lines of communication, reporting protocols, and defining management structure.

The balance of this article progresses as follows. Part two examines the significant factors in the whistleblower's decision-making process and ethical reasoning. Part three discusses the current state of our corporate culture – fertile ground for whistleblowing. Part four focuses on nongovernmental, external whistleblowing and describes the protections and administrative processes provided by Sarbanes-Oxley. Part five presents cases for discussion. Part six presents the conclusion and take-away ideas.

### **Whistleblowing Defined**

Whistleblowing, as defined by Boatright (2000, p. 109), is “the voluntary release of non-public information, as a moral protest, by a member or former member of an organization outside the normal channels of communication to an appropriate audience about illegal and/or immoral conduct in the organization or conduct in the organization that is opposed in some significant way to the public interest.”

This definition can be broken down into six significant elements:

- (1) Voluntary release by a current or former employee;
- (2) Disclosure of non-public (insider) information;
- (3) Moral protest;
- (4) External disclosure;
- (5) Disclosure regards illegal or immoral conduct; and
- (6) Conduct is adverse to the public interest.

A like definition, provided by Keenan and McLain (1992), identifies whistleblowing as the voluntary release, by a present or former organizational member, of illegal, unethical or illegitimate activities under the control of organizational leaders, to parties who are able to take corrective action.

### **The Whistleblowing Decision**

A review of the literature on whistleblowing behavior identifies two major considerations in the whistleblower's decision making process: (1) the perceived seriousness of the conduct and (2) the costs and benefits of whistleblowing. For example, research by Miceli and Near (1985 and 1992) and Singer, Mitchell and Turner (1998), found a positive relationship between the perceived seriousness of the subject conduct and the likelihood of whistleblowing. Research conducted by Ellis and Arieli (1999) and Near and Miceli (1995), concluded that potential whistleblowers carefully consider costs and benefits before taking action. Other significant factors include the employee's

beliefs about the causes of the conduct (Weiner, 1995; and Kent & Martinko, 1995) and, finally, the employee's perception of management's credibility and response (Stevens & Kristof, 1995; Healy, 1999; and Near & Miceli, 1995).

As discussed by Jennings (2003), an employee has limited options when dealing with the conflict of personal values versus workplace wrongdoing. Simply stated, the options include staying or leaving, speaking up or keeping quiet. The mix of options, as summarized by Jennings, is presented in Table 1.

**Table 1. A Whistleblower's Options**

Do Nothing	Stay
Do Nothing	Leave Organization
Feed rumor mill <sup>1</sup>	Stay
Feed rumor mill	Leave
Disclose internally <sup>2</sup>	Stay
Disclose internally	Leave organization
Disclose externally	Stay
Disclose externally	Leave
Leave	Disclose externally <sup>3</sup>
<sup>1</sup> Refers to conduct by employees in which they <u>do not</u> use formal or information avenues within the organization to report violations. This type of whistleblowing serves to share the burden with others.	
<sup>2</sup> To report conduct within the company.	
<sup>3</sup> Denotes that some whistleblowers disclose before they leave while others disclose after they leave.	

Source: Jennings (2003)

### **Ethical Theories and Whistleblowing**

To develop a clearer understanding of whistleblowing, we associate it with traditional ethical theories, specifically Utilitarianism and Deontology. As discussed by MacKinnon (2004), Utilitarianism provides that decisions (regardless of motive) should be directed to provide the most benefit to the greatest number of people (or stakeholders), with harm to none. Most of us are utilitarian in that we focus on the consequences of our actions. Utilitarianism is, however, challenging in that it requires considerable personal judgment regarding the costs and benefits of decisions (who benefits and who gets hurt).

Deontology is the theory that any decision made today would be suitable to everyone having the same facts. Immanuel Kant, an 18<sup>th</sup> century philosopher, advocated deontology arguing that an action is morally right only if the actor is motivated by goodwill. Deontology looks less at consequences and more at the process. For example, an employee who follows company rules because it's the right thing to do is following Deontology, specifically Kant's theory (De George, 1999; and Woodrow, 1997).

The issue for consideration, whistleblowing, requires the resolution of the conflict between personal values and workplace wrongdoing (conflicting loyalties). Such conflict is resolved through ethical reasoning, i.e., as the process of working out the consequence of moral rules and a proper concern for the welfare of others. Both sides must be weighted and a decision made as to their value. Through ethical reasoning, employees decide on a course of action based on their own beliefs and understanding of established policies and law.

According to Mujtaba (1997), ethical reasoning involves honest reflection on underlying motive, potential harm, and operating values and rules. In this context, De George (1999) proposed five conditions that should be met and considered by employees concerning their moral obligation to blow the whistle:

- (1) The firm, through its product or policy, will do serious and considerable harm to employees or to the public.
- (2) The employee has advised his immediate superior of his concerns regarding the product or policy.
- (3) Failing an effective response by the employee's superior, the employee exhausts the internal procedures and possibilities within the firm.
- (4) The whistleblower must have, or have accessible, documented evidence that would convince a reasonable, impartial observer that his view of the situation is correct.
- (5) The employee has good reason to believe that by going public the necessary changes will be brought about.

Whistleblowing can play an important role in the internal and social control of an organization for the good of all. According to a recent survey conducted by Read and Rama (2003), within the past two years 71% of chief internal auditors have received whistleblower complaints, 65% of which were found to be valid. As discussed by Chiu (2003), whistleblowing is acquiring a new significance as a mechanism of social and internal control.

### **Corporate Culture**

An important consideration in the whistleblower's decision-making process is the subject culture and his or her perception of that subject culture. Culture guides both individual and collective behavior. Culture consists of basic beliefs, values and norms. It influences how decisions are made within the organization, determining the style of management and behavior. According to Sims and Brinkmann (2003), leadership is the critical component of an organization's ethical culture; leadership creates, reinforces and provides for change. According to Schein (1985), an organization's management (leaders) influences and encourages corporate culture through signaling, employing five primary mechanisms: (1) attention; (2) crisis management; (3) role modeling; (4) rewards; and (5) selection.

Schein's (1985) first mechanism, attention, operates on the premise that what drives management drives employees. For example, if management is driven by profit

above all, so too are employees. Schein's second mechanism, crisis management, provides that management's values emerge during times of crises. A crisis can be any stressful event that threatens the organization, its operations, reputation, financial standing or survival. Crisis situations could include product recalls, lawsuits, whistleblowing actions or failing to meet profitability expectations. According to Schein, the manner in which management assesses a crisis, develops contingencies, manages and controls information, and communicates expectations signals employees regarding what counts. Schein's third mechanism, role modeling, is the example set by management for ethical behavior. In other words, actions speak volumes; employees will believe what they see. Schein's fourth mechanism, rewards, suggests that a reward system also signals employees regarding what's important...sales, profit or ethical behavior. Schein's fifth and final mechanism, selection, signals values and serves to both reinforce and control the subject culture—again what's important and what's not.

### **Formal Code of Ethics**

Much has been written on the impact of a formal codes of ethics of corporate culture and ethical behavior. Most U.S. companies have formal codes of conduct. According to Franze (2003), a formal code of ethics generally includes procedures for handling: (1) conflicts between personal and corporate interest; (2) corporate theft; (3) improper use of corporate or insider information; (4) inaccurate financial reporting; and (5) falsification of company records and financial statements.

Considerable research, however, has reported no relationship between the existence of a code of ethics and improved ethical behavior by managers (Cleek & Leonard, 1998; Morris, Marks, Allen & Newman, 1996; and Ekin, Scrap & Hande, 1999). According to Gibson (2000, P. 6), a code of ethics waffles when the "issues are vague, novel or difficult." A current day example of code failure is Enron, which by all appearances was an excellent corporate citizen armed with an advanced code of ethics. As concluded by Sims, et al. (2003, p. 243), "business ethics is a question of organizational 'deep' culture rather than of cultural artifacts like ethics codes, ethics officers and the like."

### **Commission of Public Trust and Private Enterprise**

The state of the American corporate culture was examined in June of 2002 by the Conference Commission on Public Trust and Private Enterprise (Commission). The Commission, a non-profit independent membership organization, was convened to examine the circumstances which led to the many accounting and capital market failures of 2000 and 2001. Charged with making recommendations for improved corporate governance and restoring public trust, the Commission's study provided recommendations on executive compensation, shareholder relations, accounting and audit practices, and ethics oversight which, of course, included whistleblowing.

As developed in the Commission's report (Commission, 2002), the foundation of corporate culture is built on the agency theory. Agency theory predicts and explains the behavior of parties involved with the company, providing that the principals (stockholders) can assure themselves that the agent (management) will make optimal decisions only if appropriate incentives are given and only if the agent is monitored (Watts & Zimmerman, 1983). Agency problems also arise with other stakeholders – creditors, equity holders, employees, suppliers, customers and communities, each having different objectives. Monitoring, or oversight, is primarily the charge of the Board of Directors. Monitoring is also expected from internal auditors, external auditors, analysts and, of course, the Securities and Exchange Commission. Whistleblowing results when traditional monitoring, oversight and corporate governance fail.

According to the Commission's report, there is a widespread perception of corporate dishonesty. For example:

- (a) 46% of the public believes every company is guilty of some wrongdoing;
- (b) 79% of the public believes corporate executives take actions to benefit themselves at the expense of the corporation; and
- (c) 73% of the public believes that corporate executives can't be trusted.

The Commission's report also cited a KPMG employee survey (2000) that suggested:

- (a) 60% of employees have observed illegal or unethical conduct on the job within the last 12 months;
- (b) 37% of employees have observed serious misconduct which could result in a significant loss of public trust if known;
- (c) 73% of employees believe that misconduct is caused most often by indifference, cynicism and pressure; and
- (d) 64% of employees believe that management would respond appropriately if made aware of misconduct.

### **Whistleblower Protections and Sarbanes-Oxley**

In response to the widely publicized corporate scandals of Enron, Tyco, and others, Congress passed the Sarbanes-Oxley Act (SOX) in July of 2002. The act contains an array of civil, criminal and administrative provisions designed to promote not only improved standards of corporate governance, but also a comprehensive framework for enforcing whistleblower protection (including attorneys and auditors).

Title VIII of the SOX, designated as the Corporate and Criminal Fraud Accountability Act of 2002, "provides protection to employees (i.e. whistleblowers) against retaliation" by publicly held companies and its agents, "because the employee provided information to the employer or a Federal agency or Congress relating to...fraud against shareholders." In addition, employees are protected "when they have filed, testified in, participated in, or otherwise assisted in a proceeding filed or about to be

filed” against a publicly held company relating to any such violation (i.e. securities fraud). To secure protection under SOX, employees claiming retaliation must file a complaint with the Department of Labor (DOL) within 90 days of the violation (unfavorable personnel action) and prevail on the following:

- (1) That the specific employee activity is protected (disclosures discussed above);
- (2) That the employer (or agent) actually or constructively knew of, or suspected, such activity;
- (3) That the complaint relates to conduct the employee “reasonably believed” to be a violation;
- (4) That the employee suffered an unfavorable personnel action;
- (5) That the protected behavior was a contributing factor in the unfavorable personnel action (e.g. discharge, demotion, suspension, threats, harassment, or discrimination); and
- (6) That the complaint was properly and timely filed (in writing within 90 days of alleged violation).

Following receipt of the complaint and a prima facie showing, the DOL will conduct an investigation. If the DOL finds in favor of the employee, it will order an immediate reinstatement. Either party may appeal and is entitled to an on-the-record hearing. A prevailing employee may be awarded make-whole relief, including reinstatement, back pay with interest, and compensation for special damages (litigation cost, attorney’s fees and so forth).

According to John Spear (personal conversation, February 3, 2004), the DOL’s contact agent, 191 complaints have been filed since the enactment of SOX through February 2, 2004. Mr. Spear cautions that the actual protections of the act are tricky, advising: (a) protection is provided only in securities fraud matters; (b) there is no protection if an employee’s complaint is made to the news media; and (c) protection may be voided where a valid business reason existed for the adverse personnel action. Importantly, the SOX expressly preserves employees’ rights under state laws.

State protections, however, for private-sector whistleblowers vary significantly. According to the Government Accountability Project, a non-profit organization that assists whistleblowers, only 19 states have actually enacted statutes offering legal protections to private-sector whistleblowers. Forty-two states have adopted a “public policy” exemption providing that private-sector employees cannot be fired for blowing the whistle on an issue of public welfare (e.g., health and safety).

### **Case Studies**

Armed with the above, two current day whistleblowing cases are presented for consideration: Sherron Watkins of Enron and David Welch of Cardinal Bankshares Corporation.

According to Baynes (2002), Sherron Watkins, one of the whistleblowers named *Time’s* “Person of Year 2002,” was a Vice President at Enron and a CPA with more than

20 years of professional experience. During the course of her employment at Enron, Ms. Watkins acquired knowledge of illegal wrongdoing (in the spring of 2001) and disclosed it to her supervisor's supervisor (late August 2001). Failing reform, Ms. Watkins continued at Enron and, in fact, took advantage of insider information in selling her (failing) Enron stock. Following the collapse of Enron, Ms. Watkins signed a book deal (receiving a \$250,000 advance) and joined the speaker's circuit at \$25,000 per speech.

According to Sims, et al. (2003), Enron embraced a culture that rewarded cleverness – one that would push the limits. Enron's management encouraged an aggressive and competitive culture; the company's response to crisis was creative accounting. Enron's reward system signaled a culture of win-at-all-costs. Management utilized a "rank and yank" policy where the bottom 15-20% producers were terminated; it placed a premium on hiring the best and smartest people.

What questions are posed and lessons learned from the above case and preceding literature review?

1. Did Enron's corporate culture matter? Yes. Enron's culture and leadership facilitated the ethical and financial collapse of the company. A review of Schein's (1985) five primary mechanisms supports this conclusion: (a) attention – the attention was on profits at all costs; (b) crisis management – illegal and unethical accounting practices; (c) role modeling – misrepresentations by management; (d) rewards – winner takes all; and (e) selection – rank and yank; the best and brightest.
2. Did Enron have a code of ethics? If so, did the code provide whistleblower protection? Yes and yes. As discussed above, Enron was fully equipped with ethical tools including an ethics officer. As illustrated, a code of ethics without consistent and effective communication and enforcement is meaningless.
3. Was Ms. Watkins a whistleblower? No. There was no moral protest or external disclosure. As described by Jennings, the horse was out of the barn when she called 911. Ms. Watkins was part of the management team that engineered the structure and strategies of the company. She took no risks – the company was already under investigation.
4. Were whistleblower protections, federal or state, considered a factor? There is no evidence that such protections were a factor.

In contrast to the above, we next examine the case of David Welch (Welch v. Cardinal Bankshares Corp., DOL, 2003). Mr. Welch, a CPA with more than 15 years of professional experience joined Cardinal Bankshares Corporation (CBC) as its CFO in late 1999. During the course of his employment at CBC (October 2001), Mr. Welch acquired knowledge of illegal wrongdoing and disclosed the same to his supervisor. Following the passage of Sarbanes-Oxley (July 2002), Mr. Welch disclosed his concerns of illegal wrongdoing to the outside auditors (August 2002) and subsequently to the bank's examiners (August 2002). On August 14, 2002, Mr. Welch advised the Board of Directors of his refusal to certify the company's financial statements because of misstatements. Mr. Welch subsequently engaged an attorney (at his own expense) and advanced his concerns to the company's audit committee and outside auditors. On September 25, 2002, Mr. Welch was terminated for work-related failures and refusing to



meet without assistance of counsel. Mr. Welch filed a timely petition for protection under Sarbanes-Oxley. On January 24, 2004, a decision was entered in Mr. Welch's favor by the DOL. Mr. Welch was reinstated to his former position with back pay and special damages.

What questions are posed and lessons learned from this case and literature review?

1. Does corporate culture matter? Yes. CBC's culture and leadership facilitated the ethical failure of the company. A review of Schein's (1985) five primary mechanisms supports this conclusion: (a) attention – the attention was on supporting management (insiders) at all costs; (b) crisis management – illegal and unethical practices; (c) role modeling – misrepresentation by management; (d) rewards – go along to get along; and (e) selection – only team players need apply.
2. Did CBC have a code of ethics? If so, did the codes provide whistleblower protection? Yes and no. As evidenced above, a code of ethics without consistent and effective communication and enforcement is meaningless.
3. Was Mr. Welch a whistleblower? Yes. There was a voluntary external release by a current employee of non-public (insider) information as a moral protest regarding illegal or immoral conduct which was perceived as being adverse to the public interest.
4. Were whistleblower protections, federal or state, considered in this case? Yes. Mr. Welch researched the protections afforded by the SOX before blowing the whistle.
5. What ethical theory was employed in this case? Utilitarianism, the personal judgment regarding the costs and benefits of the decision (who benefits and who gets hurt).

## **Conclusion**

The above discussion serves to illustrate the complexities of whistleblowing. Below are several ideas summarize the practical implications of this article.

1. Whistleblowing can play an important role in the internal and social control of an organization for the good of all.
2. A confidential internal whistleblowing system (hotline) can provide a valuable outlet for concerned employees and add value to the organization.
3. Whistleblowing should be encouraged through a more open culture that is sympathetic to employees having reasonable concerns.
4. An organization's ethical culture should be formally challenged and regularly evaluated.
5. A code of ethics is only effective when communicated and enforced consistently throughout the organization.
6. Manager's actions speak louder than words.
7. Ethics cannot be legislated.

It is undisputed that whistleblowers play an important role in corporate governance today. We must not forget, however, that whistleblowing is more than an idea for discussion; it is an action undertaken by individuals—individuals that must live

with the consequences. Prospective whistleblowers should consider the following remarks. Despite efforts by the government to level the playing field, a whistleblower is still likely to be negatively affected by his or her decision. The truth is that corporations, in large part, remain adverse to and intolerant of whistleblowers, thus leaving substantial room for improvement. Of course, whether one is deterred by this knowledge is a matter of personal conviction. The important thing is that the whistleblower be prepared— informed of the risks, aware of his rights and committed to his chosen course of action.

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