

# Acting Ethically: Moral Reasoning and Business School Student Behavior

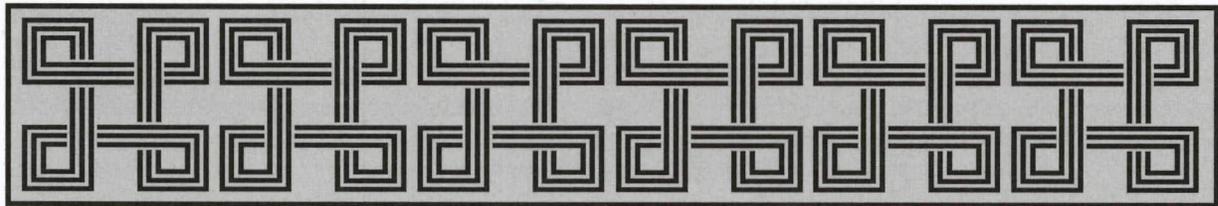
Anthony F. Buono, *Bentley University*

Donna Fletcher-Brown, *Bentley University*

Robert Frederick, *Bentley University*

Gregory J. Hall, *Bentley University*

Jahangir Sultan, *Bentley University*



## Introduction

Although society continues to place increased emphasis on ethics and corporate conduct, recent events have, once again, shaken faith in our business system. Over the past decade, a disturbing number of well-known, highly admired corporations have fallen into corporate infamy. Although it appears that dubious deal making, excessive risk taking, and questionable accounting and financial practices lie at the heart of many of these problems, the abuses over the last several decades suggest that problems run much deeper, raising concerns about the basic orientation of many of our business executives. While corporate cultures, subcultures, and related pressures can readily influence such misconduct (see Cialdini, Petrova and Goldstein, 2004; Greenberg, 2002), many of these ethical lapses were committed by graduates of our business schools (Kaplan and Kowitt, 2009).

As a result, increased pressure is being placed on business schools to provide more ethics education. Business schools have been challenged to help students develop the skills and tools they need to identify ethical issues, analyze the implications for relevant stakeholders, and provide a foundation for ultimate business decision making. Indeed, a broad array of critics (e.g., Ferguson, et al, 2011; Ghoshal, 2005; Gordon, 2011; Miller, 2009) suggest that much of the underlying blame for recent scandals is based on a lack of ethical sensitivity among managers and on the amoral, shareholder supremacy underpinnings of business education. As a result of such concerns, the Association to Advance Collegiate

Schools of Business International (AACSB) has increased its emphasis on the inclusion of ethics in business curricula (AACSB, 2004), though it stopped short of mandating a required business ethics course. The UN Global Compact's Principles for Responsible Management Education initiative has called for a basic rethinking of the approach taken in business schools, challenging faculty to emphasize more fully the creation of sustainable value for a broad range of stakeholders. Other professional associations – from the Aspen Institute and the European Foundation for Management Development to Net Impact – are also championing the change, pushing for businesspeople and students to use their talents to create a more socially inclusive and environmentally sustainable world.

While calls for program reassessments and curricular change in business schools have become prominent (see, for example, Buono, Carteron and Gitsham, 2012; Muff, 2012; Thomas and Cornuel, 2012), Pfeffer (2003) has questioned the extent to which unethical business behavior is a result of the type of theories and models typically taught in business schools. Instead, he proposed that those seeking business degrees may already have personal moral philosophies that are consistent with immoral or amoral business behavior. A recent study by Neubaum et al (2009), however, suggests this may not be the case. Based on Forsyth's (1992) questionnaire measuring personal moral philosophies, Neubaum and colleagues did not find any significant difference between those of incoming business and non-business students. Moreover,

they did not find any evidence to suggest that the personal moral philosophies of freshmen business students were different from business seniors, although the seniors were more likely than freshmen to believe that sustainability was important for business and that economic factors were not the only important measures of business performance. Therefore, an underlying question concerns the level of moral reasoning of beginning business students and whether that reasoning is related to their behavior.

### **The Study**

The present study assesses the moral reasoning of an incoming cohort of students enrolled at a business university and the relationship between such reasoning and their behavior. The research design includes an assessment of ethical reasoning as measured by the defining issues test (DIT-2) and ethical behavior as measured through a trading room simulation with an opportunity for insider trading.

### **The defining issues test**

The defining issues test, based on Kohlberg's (1984) theory of moral development, is a paper-and-pencil assessment and one of the most well-documented approaches – in terms of reliability and validity – to measuring moral reasoning (see Wilhem, 2010). Kohlberg's framework is based on the premise that moral judgment develops through a series of stages, beginning with self-interest (which he referred to as "pre-conventional"), evolving through respect for society's laws and conventions ("conventional"), and, in some individuals, developing to the highest level of principled reasoning ("postconventional"). Although Kohlberg posited that these were "hard" stages, in which a person's judgments were based on their current level of reasoning (although there could be overlap during a transition between stages), the DIT takes a "softer" approach in that an individual's moral development can reflect a range of these stages, or what is referred to as schemata, in their development (see Bailey, Scott, and Thoma, 2010).

Based on the notion that moral judgment involves distinctive ways of defining and evaluating moral problems (see Rest, 1979), the DIT presents subjects with a series of moral dilemmas. Each dilemma is followed by a number of items for the participant to consider in solving that dilemma. The participant rates and ranks the importance of each item and chooses a course of action to resolve the dilemma. The most used

index of the DIT is its measure of principled reasoning or the P score, which Rest (1979) argued was a reliable measure of moral development.

The DIT-2 is an updated version of the original DIT, which was devised over 30 years ago. It is a shorter test with five contemporary stories that present moral dilemmas. After reading each story, the respondent is asked to complete three different tasks. The first is to select the subsequent action the character in the story should take from three listed options. The DIT-2 also contains 12 possible reasons for making this decision. The second task is to rate the importance of each of these 12 statements on a 5-point scale. The final task is to select four of the 12 deemed most important, ranking them in order of importance. DIT-2 schema scores are computed on the basis of these four ranked statements. The calculated schema scores are expressed as the ratio of an individual's score for each schema to the possible score, ranging from 0 to 99.

Reflecting Kohlberg's model, research suggests that DIT items are clustered around three general moral schemas: arguments that appeal to (1) personal interests (Personal Interest); (2) maintaining social laws and norms (Maintaining Norms); and (3) moral ideals or theoretical frameworks for resolving complex moral issues (Postconventional) (see Bebeau and Thoma, 2003). Bebeau and Thoma (2003) also note that the DIT-2 test is internally reliable and improves on the validity of the original DIT. Validity for the DIT has been assessed in terms of seven criteria, including longitudinal gains in moral reasoning. In particular, Bebeau and Thoma (2003) note that a review of 12 studies of freshmen to senior college students show effect sizes of .80.

Although Kohlberg's (1984) stage theory is founded in cognitive development, he offered an important clarification that "the attainment of a moral stage requires cognitive development, but cognitive development will not directly lead to moral development. However, an absence of cognitive stimulation necessary for developing formal logical reasoning may be important in explaining ceilings on moral level." In essence, one's social and life experiences are important factors in moral development. Thus, external, situational factors may influence moral development, especially with people at lower developmental levels. According to Maeda, et al (2009), for example, individuals who prefer the maintaining-norms moral schema tend to value existing social norms as the basis of a coopera-

tive society and are suspicious of any attempt to change the status quo. On the other hand, people who prefer the postconventional moral schema are more willing to question existing social norms and are more open to social change.

Philosophers and psychologists have long attempted to understand the relationship between moral thought and moral action. Kohlberg (1984) postulated that “persons at each higher stage of moral reasoning are more likely to act with responsibility, that is, to act in accord with choices about situations that they judge to be right when they were somewhat removed from the situation itself.” The DIT has also played a major role in ethics-related research, with more than 500 published articles in which the instrument was used with college students (see Bailey, et al, 2010; King and Mayhew, 2002). Accordingly, the present study explores the relationship between moral thought (DIT-2) and moral action (trading room simulation) of business school students.

### Ethical decision making and behavior

The study draws on Rest’s (1986) four-component model of individual ethical decision making and behavior. Rest posited that to be a moral agent an individual must be able to (1) recognize a moral issue, (2) make a moral judgment, (3) resolve to place moral concerns ahead of other concerns (i.e., establish moral intent), and (4) act on those moral concerns (see Figure 1). He argued that each component in the process was conceptually distinct and that success in one stage did not imply success in any other stage.

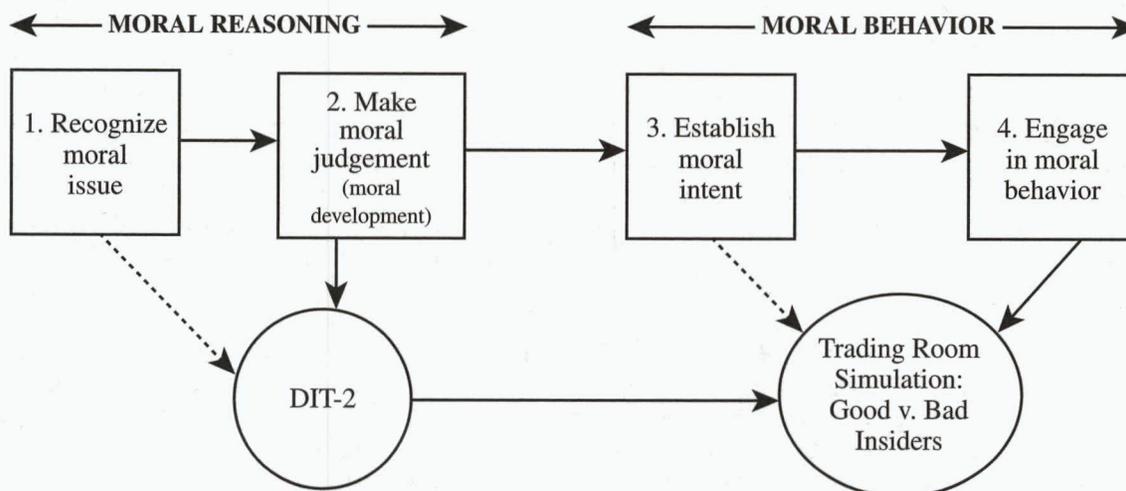
For example, a person with a well-developed sense of moral reasoning (Component 2) will not necessarily have greater resolve to act morally (Component 3). Much of the empirical research conducted in the context of this model has involved either Component 2, called moral development by Kohlberg (1976) and Rest (1979, 1986), or the relationship between Components 2 and 4, linking moral development with action.

As reflected in Figure 1, DIT-2 scores are used to assess the level of the student’s moral reasoning (judgment). Their decision to either accept or reject insider information during the trading room simulation is used as a measure of their moral behavior.

### Trading simulation: Insider trading as an ethical issue

The ethics of insider trading has been extensively debated in the literature. Engelen and Van Liedekerke (2007) provide an excellent summary of two main schools on the legality and ethicality of insider trading. One strand of the literature takes the position that insider trading should be considered a fair reward for the management that produces the valuable information. In essence, since these individuals (insiders) developed the privileged information they should be allowed to trade ahead of the general public. Because insiders take huge risk in producing this valuable information, they should be allowed to gain from trading on it. In addition, by allowing insiders to release information through their trading, market prices become more informative and liquidity is improved.

Figure 1. Ethical Decision Making and Behavior



Adapted from Rest (1986)

In contrast, another strand of the literature sees insider trading as unfair because it creates undue price volatility. Critics also point out that ordinary shareholders are not able to profit (or avoid losses) from trading because they lack access to this privileged information. Overall, this literature argues that insider trading is unethical. While Engelen and Van Liedekerke (2007) attempt to bridge the gap between the two camps by distinguishing informational efficiency from market manipulation, they also point out that "At the policy level, there is now more or less consensus that insider trading is on the whole bad and should be banned." Our study design follows this policy consensus, and students participating in the trading simulation were told that insider trading is both illegal and unethical.

Several trading simulations and scenarios have been used to examine ethical behavior in this manner. As part of a research project examining the ethics of undergraduate business students, Persons (2009), for example, found that the majority (81%) of the respondents believed that making a profit from insider trading was unethical. However, he also found that almost half (45%) of the students did not find insider trading to be unethical if a loss was avoided and the insider owned the stock. He posited that those students who did not find insider trading unethical believed that they were entitled to protect themselves from a loss or that they would not get caught trading on insider information. Along similar lines, a study of finance professionals in Finland, Hartikainen, and Torstilla (2004) found that almost one-quarter of respondents (24%) accepted insider trading, even though it was a clear breach of Finnish law.

In a small sample of college juniors, Abdolmohammadi and Sultan (2002) studied the relationship between ethical reasoning and insider trading using the DIT and a competitive stock trading simulation. Insider information was given to 24 of the 52 students in the study that provided prior knowledge of the settlement for a lawsuit for dumping radioactive waste. The students were given \$10,000 in hypothetical funds to trade on this information and competed for up to \$100 in cash prizes based on the profits made during the simulation. Fifteen of the 24 students admitted to trading on this insider information, and they found that students with higher moral reasoning (higher P scores on the DIT) were less likely to trade on insider information than those with lower moral reasoning.

The present study is an extension of Abdolmohammadi and Sultan's (2002) research. While their study focused on college juniors, the present research project focused on the entering business school class of 2014. Similar to Abdolmohammadi and Sultan (2002), in addition to completing the DIT-2, the class of 2014 also participated in a trading room simulation with the opportunity for insider trading. Prior to coming to campus, students received an e-mail attachment providing an overview of the simulation and a link to a trading practice session. They were encouraged to use this link, which also provided information on the dynamics associated with the market microstructure (e.g., bid/ask prices; price taker versus price maker) and the mechanics of using the simulation software. Also included was a description of insider trading and statements that insider activity is unethical and illegal. Students were informed that insider trading can range from acting on insider information to passing on insider information to one's "club" (e.g., family, friends, peer group). The students also received information on the effectiveness of SEC regulation of insider trading, i.e., it is hard to monitor and prosecute. All this information was reviewed in the trading room prior to the simulation.

The simulation model in the present study is based on an interactive trading platform developed at Carnegie Mellon University. In this trading platform, students have the opportunity to trade three stocks, starting with an initial position (endowment) in each of the stocks. Students can trade (i.e., buy or sell) the stocks for a total of three trading periods or sessions. At the end of each trading period, actual earnings are announced. Companies are then valued based on a multiple of the earnings. The multiples at which these companies trade, or the P/E ratios of the companies, is provided to the students. Students are also given six equally likely earnings per share for each company. The earnings of the companies are independent of each other. Students are also able to borrow and short-sell the stocks. The interest rate on cash is 0%.

Just prior to the trading session, insider information on actual earnings was passed via a window message to six randomly selected students per stock (18 out of 45 student participants) in each session. The insiders had the ability to accept or reject the insider information. If they chose to accept, they were considered "bad insiders"; "good insiders" did not accept the information. Student portfolio value at the

completion of the trading period determined their performance. As an incentive to take the simulation seriously, a cash prize of \$100 was given to the student with the highest portfolio value in each trading simulation. Nineteen trading sessions were used to accommodate the students in the entering class of 2014.

### Results

Of 962 entering freshmen, 921 took the DIT and 908 participated in the trading room simulation. Some students took the DIT but did not complete the TR simulation. Others completed the TR simulation but not the DIT. Further, some students did not provide a valid ID when trading or completing the DIT. Finally, there were some missing data on the DIT in this matched group. After adjusting for the missing data, the resulting sample size consisted of 800 valid observations. The students were mainly from New England (58%) and the Mid-Atlantic region (21%), with smaller numbers from other U.S. regions (8%) and international (13%) locations.

The demographic composition of the sample is in Table 1.

### Baseline ethical reasoning

Table 1 also lists the descriptive statistics for the three moral schemas – preconventional, maintaining norms, and postconventional – for the study population. The moral reasoning of the class of 2014 was in line with prior findings of college freshmen. Maeda, et al (2009), for example, using data obtained from 1998 to 2005 on students from 65 different institutions, reported an average P score for freshmen year students of 30.98 (with a standard deviation of 13.97). Similarly, in the present study, the higher mean P score for women is statistically significant ( $p = .0002$ ), confirming prior DIT study results that females have higher scores than males. Table 1 also breaks down the three moral schemas for different student groups – international students, those accepted into the honors program, those planning to participate in the university's service-learning program, athletes,

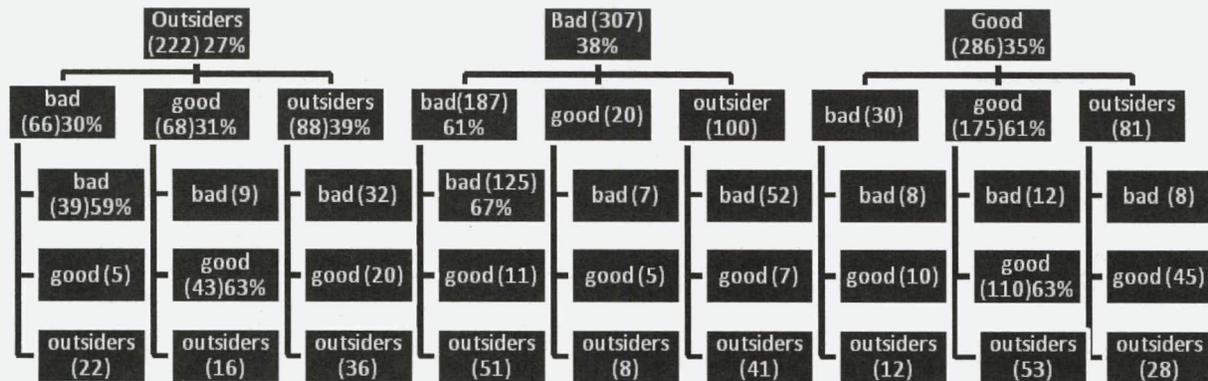
**Table 1. Descriptive Statistics of the Sample with Personal Interest (PI), Maintain Norms (MN), and Postconventional (P) Schema Scores**

Individual Characteristics	N	PI Score	MN Score	P Score
Gender <sup>1</sup>				
Female (Mean) (Standard deviation)	341 (42.6%)	28.342 (12.195sd) <sup>2</sup>	33.419 (11.991)	32.878 (13.348)
Male	459 (57.4%)	30.868 (12.908)	34.306 (3.275)	28.001 (13.211)
<b>TOTAL</b>	<b>800</b>			
International	103 (12.9%)	27.918 (11.283)	35.992 (12.264)	28.999 (13.348)
Honors	85 (10.6%)	27.583 (12.687)	31.405 (13.1407)	35.250 (13.589)
Service-Learning	111 (13.9%)	29.184 (12.665)	34.349 (13.385)	29.989 (15.599)
Athletes	120 (15%)	31.486 (12.401)	32.836 (11.727)	29.189 (12.712)
ALANA	130 (16.2%)	31.709 (13.405)	33.317 (12.989)	28.507 (13.112)

<sup>1</sup> The difference between the female and male P scores is statistically significant using Satterthwaite t-test =5.13  $p = .0001$ .

<sup>2</sup> Standard deviation noted in parentheses.

**Figure 2. Results of the Trading Room Simulation**



and ALANA (African Americans, Latinos, Asian Americans and Native Americans) students.

**Trading room simulation results**

Figure 2 presents the results of the TR simulation. As mentioned, insider information on actual earnings was passed to six randomly selected students per stock, or 18 out of 45 participants in each session. Each could accept or reject this information, with the former choice making them “bad insiders.” Students were deemed outsiders if the program did not randomly select them to receive insider information.

The interactive trading platform software allows researchers to assign insider and outsider status across trading sessions. Recall that a trading simulation has three consecutive sessions, each lasting five minutes, representing one physical year. Compared to the “bad insiders” (i.e., students who accepted insider information), students picked randomly as outsiders and students who were offered the privileged information but chose not to accept it (“good insiders”) did not have any information advantage. During the first trading session, there were 222 outsiders (27%), 307 bad insiders (38%) and 286 good insiders (35%). Of the 307 bad insiders, approximately 61% (187 students) remained bad insiders in session 2, while 20 rejected the information and became good insiders. One hundred of these individuals did not receive insider information in the second trading session and subsequently were identified as outsiders. Of the 187 bad insiders in session 2, 69% (125 students) remained bad insiders, 11 switched to good insiders, and 51 did not receive insider information in the third and final session. This last group of 51 students would therefore be labeled as “bad, bad, outsider” in the trading room session tree results. There appeared to be a strong proclivity

to continue behavior established in the first trading session. For example, once a student accepts inside information, behaving as a bad insider, given the opportunity to accept inside information in subsequent trials, the student is likely to remain “bad.”

Table 2 provides an overview of the results of the relationship between moral intent and behavior, by comparing the Personal Interest, Maintain Norms, and Postconventional DIT scores of “good” and “bad” insiders. Of note is the consistent finding that good insiders have higher P scores (the highest possible moral schema) and lower personal interest scores (the lowest possible moral schema) than bad insiders, regardless of the trading session.

Table 3 provides the average P score for good and bad insiders, aggregated over each trading session. For example, the 263 good insiders in trading session 2 are calculated by summing the number of good insiders across row 2 (68+20+175) in Figure 2. The difference in the P scores for good versus bad insiders is statistically significant in all cases, confirming the observation that the higher the P score, the less likely the student will accept insider information.

**Summary and Conclusions**

The results presented here are based on an assessment of an incoming class of business school students, examining their moral reasoning and selected behavior as they begin their undergraduate program. Although the ability to capture and quantify moral reasoning and motives for related behaviors is fraught with challenges, complexities, and nuances, the results suggest that the current focus on business ethics and efforts to enhance the moral reasoning of business students are worthwhile endeavors. Similar to the belief of real insider traders (see Charness

**Table 2. Trading Room Results by DIT-2 Scores**

	<b>Personal Interest Score</b>	<b>Maintain Norms Score</b>	<b>Postconventional Score</b>
<b>SESSION 1</b>			
Good Insider ( N:286)	29.25	33.71	30.92
Bad Insider (N:307)	30.50	34.03	28.72
<b>SESSION 2</b>			
Bad/Bad (N:187)	31.32	33.85	28.03
Bad/Good (N:20)	29.24	33.71	31.99
Good/Good (N:175)	29.57	33.74	31.17
Good/Bad (N:30)	32.81	31.59	29.94
Outsider/Bad (N:66)	30.56	34.55	30.04
Outsider/Good (N:68)	26.86	34.58	32.21
<b>SESSION 3</b>			
Outsider/Bad/Bad (N:39)	29.39	34.64	31.72
Outsider/Good/Good (N:43)	26.27	35.79	31.58
Outsider/Outsider/Bad (N:32)	33.01	32.60	29.63
Outsider/Outsider/Good (N:20)	29.69	35.32	30.14
Bad/Bad/Bad (N:125)	32.43	32.99	27.67
Bad/Outsider/Bad (N:52)	29.53	34.21	28.89
Good/Good/Good (N:110)	29.20	34.01	30.77

**Table 3. Trading Room Simulation Results by Postconventional Reasoning: Good v. Bad Insiders**

<b>Trading Session</b>	<b>P Score Good Insiders (N)</b>	<b>P Score Bad Insiders (N)</b>	<b>Difference (Satterthwaite t-test)</b>
<b>1</b>	30.9238 (286)	28.7182 (307)	2.2056 (1.97; $p = .0488$ )
<b>2</b>	31.4979 (263)	28.6981 (283)	2.7998 (2.38; $p = .0177$ )
<b>3</b>	30.9371 (256)	28.7809 (292)	2.1562 (1.85; $p = .0647$ )

and Garoupa, 2000; Kay, 2003), students in the study might have felt that there was little chance of getting caught trading on the privileged information. Moreover, in light of the financial incentive (\$100 cash prize) provided to the winner of the simulation, we expected that some students would accept the inside information. While this did occur, the study found that students who did not accept insider information had statistically significantly higher P scores compared with students who did accept this information, suggesting a link between a high level of moral reasoning and moral behavior.

Given these outcomes, it appears that efforts to enhance the moral reasoning of business students could lead to increased ethical behavior in the workplace. As King and Mayhew (2002) argue, there is strong evidence that student participation in higher education is associated with gains in moral development. Graduates with high P scores could very well see themselves as “moral exemplars,” individuals who prioritize ethical considerations in their daily lives (Bailey, et al, 2010; Walker and Frimer, 2007) and choose to exhibit “moral courage” (Kidder, 2006). Similarly, individuals at the Maintaining Norms (conventional) level might have a greater tendency to rely on codes of conduct, ethics policies, and regulatory guidelines in making decisions. It could also be that individuals at the preconventional, Personal Interest level have a higher probability of engaging in unethical behavior, a concern that deserves further exploration.

A number of limitations are associated with the study. First, the relationship between insider trading during a simulation and subsequent behavior in the workplace is complex at best. Moreover, in general, college freshmen are not as well-versed in key trading behaviors – margin buying and short selling – compared with business seniors, especially finance majors. Therefore, the perceived gain to be reaped from insider trading in the trading room simulation is probably lower for the less financially acute. Hence, those not engaging in insider trading when given the opportunity may not realize the magnitude of the profit potential.

Second, it isn't fully clear that moral reasoning rather than adherence to the law was the driving factor in the rejection of privileged information by “good” insiders. The packet of material sent to the students stressed that insider trading is illegal as well as unethical. However, within the context of the simulation, college freshmen could be swayed by the low probab-

ility of getting caught being a “bad” insider and the limited effect that such insider trading would have on their reputation.

It may also be that the low probability of effect, a characteristic of moral intensity, has a bearing on insider trading. According to Jones (2004), moral intensity is a construct that captures the extent of issue-related moral imperative in a situation, which influences reasons of logic. For example, the expected value of a financial gain is the product of the magnitude of the gain and its probability of occurrence. Similarly, the expected consequences of a moral act would be the product of the magnitude of consequences, the probability that the act will take place, and the probability that the act will cause the harm (benefit) predicted. It may be that insider trading is viewed by some individuals as having a low probability of effect on the market, a low probability of being caught, or both.

Despite these limitations, the results of the research are promising in terms of the relationship between moral reasoning (as measured by the DIT-2) and student behavior (as captured in the trading simulation). Further research could explore student perceptions of the likelihood of getting caught if they act on insider information, the extent to which legal and ethical concerns influenced that decision, and how they decided on their course of action. The early findings suggest that efforts to enhance the moral sensitivity, awareness, and reasoning of business students can lead to the type of behavior we would like to see in the business world.

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*Dr. Buono, director of the Alliance for Ethics and Social Responsibility, has written or edited 14 books, including Exploring the Professional Identity of Management Consultants, 2012. Dr. Fletcher-Brown, who has published in several journals, focuses her research on derivatives, international finance, investments, capital markets, and corporate governance and compliance. Dr. Frederick, editor of Business and Society Review, has published in the areas of ethical theory and applied ethics. Dr. Hall, recipient of the Adamian Award for Excellence in Teaching, pursues research in adolescent development, behavioral implications of transition economies, and comparative educational systems. Dr. Sultan, who has published extensively in financial and economic journals, focuses on international finance and investment, financial liberalization in emerging economies, and time-series modeling.*

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