

Goodwill, Going Concern, Stocks and Flows: A Prescription for Moral Analysis

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ABSTRACT. This paper projects the decision making dilemma faced by managers when assessing moral consequences associated with planning proposals. A case is made for viewing the results of moral behavior as a capital asset. Accepting the idea that moral business behavior proportionally influences the firm's goodwill value, the author advances the recommendation that current U.S. accounting practices become involved with determining the moral wellness of the firm. The suggestion is made that stocks and flows are useful concepts in the development of a financial information system that incorporates benefits associated with morally accepted behavior. As a necessary part of the going concern operational strategy, a case is made for the preservation and advancement of the firm's moral capital. Overall, the intent of this paper is to offer a proposal which links moral behavior with financial decision making.

Ed Williams, operations manager of a highly profitable food division (one of six product groups of an international conglomerate) sat at his desk perplexed after reviewing several proposals that had been prepared by his staff. Each proposal, while staying within the bounds of legality and acceptable business practices, represented a certain characteristic that made Ed feel uneasy. For example, one of the firm's snack foods, having limited nutritional value, was targeted for the intercity areas of five large U.S. metropolitan markets. Another proposal advanced the idea of promoting an infant formula product in an underdeveloped third-world country where there would be limited consumer understanding about necessary health standards when using the product.

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A third proposal involved the elimination of a service department through forced retirement — a suggestion that potentially would reduce division overhead costs by 10 per cent.

Ed pondered the details associated with each of these proposals. Most of the analyses made sense from a profit picture point-of-view. But, each proposal had a moral flaw. Ed realized that each one had substantial, short-run financial benefits. What he had difficulty with was assessing the long-run consequence of each proposal. None of the analyses before him dealt with the future impact of morally questionable behavior on the part of his division. Eventually, Ed was tempted, given the pressure exerted by his parent company, to accept the short-run, profit laden proposals, sacrificing the morally accepted actions which in his mind may or may not result in future consequences.

What are some possible outcomes associated with ethical behavior?

What can happen to a firm that engages in maintaining high moral standards? The worst possible long-term outcome suggests certain disadvantages — competitive or otherwise. Under this scenario one could envision a competitive structure in the product market, along with other characteristics of the industry, where the extra effort and costs attributed to ethical considerations would place the firm at a net disadvantage. A second possible outcome would result in the possibility of realizing a neutral impact from upholding lofty moralistic behavior. Here, the gains and losses would possibly even out. That is, the financial sacrifices and benefits along with non-monetary considerations would represent a zero net gain. This approach still may be desirable if the

firm's management feels it is altruistically necessary to preserve some semblance of morality in the conduct of its affairs.

A third feasible result from establishing recognizable high moral standards would portray a net gain to the firm in terms of both financial and nonfinancial returns. Of these three stated outcomes, one could argue that this last outcome, and possibly the neutral outcome, are the only realistic considerations for a going concern manager to take into consideration. Without commitment to the continuous maintenance of morally accepted practices on the part of the firm, the free enterprise approach for conducting business transactions is doomed — at least in the long-run. Generally, moral consideration on the part of the firm's decision makers becomes a necessity for maintaining a competitive and financial system that has served the U.S. so well. Certainly there are reasons in the short-run to be less than enthusiastic about morality. But in the long-run it remains the only way to do business — given the American disposition to perpetuate the free enterprise system. Even in the short-run, sacrificing moral standards will bring a loud public outcry and eventual governmental intervention.

The moral bases of goodwill

The morally based efforts on the part of the responsible organization can lead to mutually compatible responses from external recipients, i.e., customers, suppliers, competitors, agents, etc. All of this hopefully will lead to intrinsic and extrinsic benefits. The net results of the various positive ethical outcomes attributed to a specific firm provides that firm with an enviable resource on which to capitalize. To the accountant, such opportunities can be translated into financial values — specifically when the firm wishes to sell or combine itself with another firm. It should be quickly noted that financial return should not be the main reason for espousing moral standards, but, it can't hurt if financial benefits are a part of the larger picture. The value of the firm's moral character (along with other attributes), however, can result in a market value of the firm that is greater than the firm's net assets. This may be construed as goodwill (Moss, 1981; Needles, 1989).

The truth is that these obviously recognizable

moral factors alone do not contribute to the recognition of *goodwill*. Other conditions such as site, location, economic advantages in the firm's production system, and an efficient marketing apparatus also may be construed, at least in a limited sense, as public spirited moral elements that contribute measurably to this value recognition. Although a firm's individual morality is difficult to measure, it is reasonable to suggest the level of ethical conduct and the reputation gained from this behavior account for a substantial portion of the *goodwill* stated on the firm's balance sheet. The moral rightness within the organization provides a base from which to gain recognition among external clients. This recognition is disguised in more conventional, all be it limited, forms of performance measures. Therefore, values associated with increased sales, market size, worker efficiency, and financial rates of return all are connected directly and indirectly to the firm's overall state of moral conduct.

When one surveys the negative side of business morality, certain costs become clear. For instance, the inability to place trust in the firm's dishonored promises and guarantees, or the recognition of untruthfulness concerning the firm's financial statements (Fisher, 1988a and 1988b), or the uncovering of corporate fraud regarding stock transactions all are liabilities that would reduce the market value of the firm's assets. Neglect of or inattention to ethical practices can be devastating in a variety of ways. Public reaction, for instance, often can be enough to debilitate such bottom line items as sales, corporate stock values, and interest rates on new bond issues. A prime example of this reaction is the demise of Ford's Pinto. While the company was able to survive in the long-run, it paid dearly in financial terms for its insensitivity to consumer welfare. It is possible to see that the lack of ethical behavior can become a liability. But, can the building up of moral climate within the organization become an asset? While it is difficult to discern with clarity the influence of this *build-up effect* on the financial value of the firm's assets, we can say at least intuitively there is a lasting influence. Given this recognition, then, moral behavior of the firm that is of significant good quality does enhance the firm's asset value. It is also reasonable to suggest that most of this enhanced moral value does eventually impact recognized *goodwill* on the balance sheet.

When does the firm's moral behavior contribute to its goodwill value?

We have already established that the firm's stated *goodwill* on the balance sheet does represent in part *some* moral quality associated with the firm. This would suggest a portion of the *goodwill* value also represents a moral advantage over some of its competitive counterparts. If all competing firms in a specific industry were equally moral, then one could suggest that external perceptions could not discriminate among these competing firms — hence no morally driven *goodwill* could evolve among these firms in the same industry. This typically would be difficult to envision, however.

Even if all firms within *an industry* were recognized as moral equals, the industry is still set apart from other industries. And that could be of substantial importance. Firms, after all, don't compete only with other firms in the same industry. They also attempt to get the general consumer interested in focusing his or her purchasing toward that industry's products rather than alternative industries' products.

There are several accounting definitions that suggest the accounting concept *goodwill* does reflect moral factors which contribute value to the firm. For example, Lisle early on reported that (Moonitz *et al.*, 1965) "*goodwill* is the monetary value placed upon the connection and separation of a mercantile or manufacturing concern, and discounts the value of the turnover of the business in the consequence of the possibilities of the customers continuing". There was a strong suggestion in this early accounting comment that the firm's reputation goes hand in hand with the perceived ethical posture of the firm.

More recently, Professor Norton Bedford, while referring to *goodwill* valuation, suggested that "These undervalued or unrecorded assets may arise from advertising and represent a type of deferred advertising cost from proper business conduct and represent the cost of building a reputation for moral and fair action, or from chance developments and represent a type of unrealized appreciation of recorded assets or such unrecorded assets as a favorable location or a differentiated product" (Bedford, 1970).

American and English law both suggest that *goodwill* is embodied in honorable ideals and practices conducted by the firm. It is the perception of these ideals and practices as being honorable that

helps in inducing customer patronage. This along with certain other considerations contribute to a realized value that is called *goodwill* on the balance sheet (Moonitz *et al.*, 1965).

The presence of a recognized creditable moral climate regarding a specific firm connotes the presence of a unique financial advantage. Strong moral credentials, assuming that all of the other factors contributing to the firm's reputation are in place, contributes positively to the firm's asset value, specifically *goodwill*. Even in the short-run one can argue that the firm with an excellent ethical reputation can have a special economic advantage.

The fact that a firm has an ethical edge that ends up in creating a noticeable financial advantage should lead to some possible reaction on the part of competing firms. Potential financial advantages, due to a firm's ethical reputation, can result in inducing other firms to pursue similar advantages — or at least to evaluate the costs versus the benefits attributed to ethical behavior. Attaining similar economic advantages of firms with high ethical profiles can be achieved in a variety of ways. The first and most obvious approach is through the duplication of recognizable ethical behavior. Another approach is involved in the acquisition of firms with first rate ethical reputations. Noting and acquiring other firms specifically for their moral climate is not presently a stated priority (Branch, 1989) in acquisition analyses employed by takeover firms, even though the merits of this characteristic are commingled with various financial variables. If and when the firm's moral virtues become an open and major consideration in merger decision making, there will be an anticipated *band wagon effect*. Of course, a great deal of work needs to be done in order to objectively measure the contributions of moral behavior to the firm's value.

Ethical reputation may not only be an economic advantage

Attaining incremental financial value through ethical conduct is realistically a long-run process that has to evolve within the context of the organization's culture. Behaving in an ethical fashion at any level in the organization currently is not done with the explicit intent to gain some kind of economic advantage. It is done because of the socially devel-

oped behavior that business managers and executives are inclined to exercise, which happens to include ethical considerations. In fact, accepting ethical standards of behavior simply for economic advantage alone, may have a chilling effect on decision makers in the firm. The economic reasoning-only approach lends itself to mercenary motives. As humans who are members of a social order, business decision makers need to behave according to the edicts of ethical standards because it is the right behavior. If such ethical behavior ends up leading to a more respectful and stable economic climate, then economic dividends can be part of the eventual outcome which also includes psychological benefits. Therefore, psychic income and financial income are twin resultants of ethical behavior that is maintained in the performance of business activities.

How strong is the resolve?

Once the consuming, producing and governing bodies say "enough is enough" and clamor for a new breed of morality, the business response could carry with it a realization that establishing creditable ethical norms may be necessary for survival. And beyond this, it may even carry with it some competitive advantage. Whether these new standards of ethics involve behavior that emphasizes a more fair and just treatment of consumers and employees or some other category of morality, the key rests with how sustained and comprehensive are the efforts (Jackall, 1988). Short-term window dressing efforts usually slip to some ineffectual level. For instance, prior to the 1970's (Benson, 1989) formalized attempts to establish strong codes of ethics or similar documents were lacking. Typically, those efforts that were made gave only lip service to ethical concerns, with very little notice directed toward monitoring ethical behavior accompanied by the application of sanctions. Until recently, accountability for ethical behavior generally was given limited encouragement by top executives. One can only suggest that business' past attempt to only window dress its ethical resolve has contributed to the current level of public disrespect toward U.S. business firms.

The critical need in advancing positive images of business morality is to establish an insistence toward appropriate behavior and to bring objectivity to the

evaluation of business morality. A number of individual approaches can be employed to enhance positive external perceptions that closely follow reality. One approach recognizes the need for strong codes of ethics with attached sanctions. Another approach calls for allowing independent groups to evaluate a firm's moral state. These groups could include interest groups, noninterest groups, independent professional organizations, academic institutions, and religious foundations. A third approach involves an internal analysis and publication of those results regarding the firm's ethical conduct. Performing creditable social and ethics audits and subsequently making their results available in such publications as annual reports, recruiting literature and news media releases could amplify positive perceptions to the internal and external publics. This objective/independent approach can be more effective than vague generalized moral pronouncements that are often portrayed through high powered advertising campaigns. Utility companies, for example, often use this advertising approach in gloating about how well they are preserving our environment.

A firm should not be totally condemned, however, for communicating its moral stances through paid advertising. Important, of course, is the content of the message, its accuracy, fairness, comprehensiveness, and the motivation behind the paid advertising approach. Communication about a firm's moral posture can bring into play a number of ethical questions, some of which I have just outlined. Once these concerns are satisfied, then, promoting moral characterization through paid advertising would be appropriate.

Effectiveness in establishing, promoting and evaluating ethical behavior that represents the *total* organization must be buttressed by a pervasive attitudinal condition that fosters substantial psychological satisfaction. This personalization of ethical concerns will lend to the natural process of policing and evaluating the firm's moral climate (Benson, 1989). This inertia of self direction toward moral ends complements the *goodwill* value that a firm represents. When there is on-going creditability, trust, and reliability, a support system of underlying mutual respect evolves. In this context the world of commerce can set enlightened social ground rules within its sphere of influence.

Ethics and the going concern idea

Many of the moral considerations that are a part of advancing the firm's *goodwill* resource also can be linked to the business' future as a *going concern* (Schnee *et al.*, 1984). The *going concern* concept and its linkage to the *goodwill* idea essentially prescribes that unless a firm is expanding its operational efforts and is consistently involved in futuristic considerations, it, the firm, will probably restrain its resources, specifically its financial assets (Gomes, 1988). This same consideration also is true regarding the firm's moral capital.

As previously implied, the organization's management must always think in terms of future development. Otherwise, attempts to maintain only a constant resource value (intrinsic as well as extrinsic) will end up risking the present levels of financial and moral capital. Hostile forces are always present to erode the financial and moral foundation of the firm. Expanding efforts to enhance the firm's moral capital is more apt to insure the present moral state than if the effort level is retained at some constant. Looking only toward preserving what exists rather than what is achievable also is restrictive and potentially regressive due to a variety of reasons, e.g., limited creativity, perceptual limitation, and limited opportunity recognition.

Imposing the *going concern* concept in business beyond the current narrow accounting framework, particularly with regard to business morality, forces management to be constantly aware of negative forces or threats to those moral growth areas inside and outside of the firm. While formal self-examination is critical to this process, informal personal self-examination as well is also an important buttress in the expansion of moral capital. The idea of moral capital, at least when it is served by voluntary actions of individuals, can be self-generating which conceivably has no limits. Moral capital in this context can be on-going.

Is moral capital a stock or flow?

The idea of "desired level of morality" takes on a changeable characteristic (expanding and contracting) rather than that of a permanent *stock* (Ackley, 1964; Ekelund, 1988). The moral state of the busi-

ness organization appears to be more a condition that reflects continuous change. The effort given to the maintenance of moral standards gives the appearance of a cost or expense (financial or nonfinancial) rather than a capital asset. The fluid nature of expending resources to achieve and maintain expected levels of moral behavior represents essentially a *flow* concept (Ackley, 1964; Ekelund, 1988). Those costs (including, financial, physical and emotional outlays) directed at attaining a desired level of morality in the organization take on the appearance of *sunk* costs (Shillinglaw, 1970). That is, the outlays are essential and unaffected by the different operational options of the organization. These costs, however, can be identified or matched with their uses and, hopefully, their accomplishments. The value expended, it seems, cannot be accumulated, stored or reserved for any extended period of time. Business morality then cannot be billed in a major sense as a *stock* but as a *flow* of continuous efforts or costs resulting in a semi-temporary perceptual condition. The author will point out later in this article some limited aspects of morality that do reflect the *stock* concept.

The perception of the firm's moral well being is on-going throughout its history. If the firm's moral state is generally viewed positive over an extended period of time, then, the firm will more than likely enjoy a good moral reputation. Should this perception change due to negative experiences, the accumulated moral reputation will change rather quickly. In order to maintain an achieved morally good perception a firm has to constantly attend to its moral responsibilities. To do anything less would lead to moral degeneration.

As stated earlier, the firm's moral character ends up influencing the *goodwill* value of the firm. This value can be identified in varying degrees at certain key points in time. Currently, however, the only formally recognized point when *goodwill* is evaluated is at the time when mergers and buyouts occur. Yet other points of recognition, but more subtle and informal are: when employee hiring takes place, when the firm is investigated by the IRS and other governmental agencies, when the firm encounters media investigations, and when products and services are evaluated by clients prior to, during, and after an arms-length transaction. These are only a few of the many thousand instances when the firm's

moral character comes under scrutiny. Each scrutinizing occurrence becomes integrated with a complex array of items that forms the firm's perceived moral character. This moral character, in turn, combines with many different factors such as financial potential and market penetration to establish a *goodwill* value. Unfortunately, this value is formally recognized at the current time only when the business is sold.

When are the benefits due to moral character realized in the accounting records?

The business decision maker currently must view those costs attributed to establishing acceptable moral behavior as operating costs whose benefits are formally recognized when the firm is sold. These benefits can and often are informally recognized. However, at such times when goods and services are sold, when people are hired or whenever the firm engages in any activity, its reputation comes into play. Ethically induced costs become the cost of doing business, necessary not only for altruistic reasons, but for financial reasons as well. Technically, the costs of promoting and maintaining ethical behavior and their corresponding benefits are never matched in the accounting records. In the U.S. this condition is the result of a host of accounting technical difficulties, managerial indifferences and professional disregard for the cause and effect relationship between ethics and financial wellness.

The manager or decision maker must be cognizant of the intrinsic role of ethical behavior in the financial achievements of the firm. Because the expenses attributed to ethical behavior and their resulting benefits are comingled among various labels or account categories, the resulting financial statements offer very little toward an analysis of this cause and effect relationship. Consequently, the decision maker is left to his or her own devices in the interpretation of strategies and attributes related to the firm's moral conduct.

Currently, the time, energy, and outlay of funds devoted to encouraging and controlling personnel behavior for ethical purposes are classified in the present day accounting systems as training and development expenses, promotion expenses, over-

head and possibly administrative expenses. They are never, to my knowledge, stated as ethical expenses or moral development costs. Similarly, sales and revenues are never broken down as income attributed to ethical behavior. There are, on occasion, accounting techniques employed to measure profit contributions attributed to promotion efforts, different product mixes, pricing discounts and quality assurance efforts, but never has there been any formal accounting techniques devoted to measuring the impact of the firm's elevated ethical standards.

Should contemporary accounting techniques be expanded?

Several conceptual changes of our current management information system approach are required to make managerial decision making inclusive of ethical matters. Accounting information and other related data sources, for example, should incorporate more than just traditional cost and revenue information which commingle moral and amoral business data. In a general sense, the information system that facilitates the decision making processes needs to make available data regarding the consequences of becoming or not becoming involved in ethical development in the organization. The business analyst needs to ferret out the specific requirements and ramifications of developing an ethical structure that is unique to his or her firm. The content of such information needs to be defined in objective terms. For example, the marketing department should consider cost/benefit analysis associated with certain contexts of truthful advertising. The simplistic revelation that "it pays to be ethical" doesn't do much to impose moral direction in decision making.

Given the current limitations of accounting practices, there appears to be a need for the accounting profession to collaborate with its social science brethren in developing an evaluation system that would enable the recording, summarizing, and analyzing of costs and accomplishments due to moral behavior. When this will happen and how it will happen depends on the eventual broad recognition that business morality is a priority matter. The initiation and promotion of sophisticated measuring and reporting techniques regarding moral behavior need a strong push by various professional

groups, e.g., certified public accountants, certified financial analysts, certified property underwriters, legal associations, etc. Justification for these proposed evaluative techniques probably will get its biggest impetus from external public pressure, the threat of enhanced government control or some other compelling requirement.

Flows and stocks can be useful concepts in accounting for moral capital

Investment activities to enhance the firm's moral behavior can be viewed as a *flow* and, to a lesser extent, a *stock*. In the case of *flows*, the concept suggests a stream of continuous resources applied to a specific need which hopefully will result in a stream of benefits. Outflows in the form of cash, facilitating equipment, and other corporate resources are expended or invested in order to achieve moral development. Inflows, on the other hand, in the form of earned cash, accounts receivable, and other assets result from the consequences of the firm's efforts to be ethically responsible. These inflows and outflows of real assets provide the basis for measuring costs and benefits attributed to the dedication of resources building the firm's moral state. The outlay of resources (outflow) hopefully will result in expanding tangible and intangible assets, including *goodwill*. This can provide a justification for investing in morality.

The measurement of net benefits resulting from investing the organization's resources in moral conduct can to some limited extent relate to the concept of *stocks*. Technically, *stocks* are viewed at given points in time as static values. But they are sources of happenings; that is, it is the dispositional properties of stocks that matter. Stocks are sources of flow. The dynamics of increasing or decreasing the *stock* values, however, can not be considered when only observing these pools of resources at a single point in time. Stocks are useful measurement tools when looking at stocks of value at various time intervals. For example, *goodwill* may be designated as the stock of intangible value attributed to the firm's special place in the industry. In this context, observing that this *stock* of resources may have different values at different points in time, one could account for these changed values by comparing stock values at differ-

ent time intervals. In other words, expanded (or reduced) values of different stocks between two different points in time does constitute a measurement technique applied to various *stocks* of resources. In theory, one could attempt to measure the *stock* of morality in the firm at year end and note any changes from previous years. Similarly, one could measure at the end of the year the *stock* of resources (assets available for moral development) and then recognize any changes from previous years. To a limited extent, a correlative relationship could be established between these two stocks — morality and assets available for moral development.

So far, the sale of the firm is the main formal approach, if not the only approach, to measure moral enhancement. Practical needs require that alternative approaches be devised in order to formulate a means to determine the firm's stock of morality. For example, opinion poll instruments coupled with imputed financial values may be a start in the measurement process regarding organization morality.

The moral reputation enjoyed or not enjoyed by the firm appears on the surface to be fluid and subject to frequent change. While morality as a resource cannot be considered in the same context as tangible assets or goods, it can be considered, however, as a highly valuable but volatile asset, one which reflects the perception of the community. There are a number of influence sources that contribute to this *stock* and its changing nature, such as changing values and expectations among consumers, the labor force, and public institutions. Other causes include unforeseen limitation of product and service performances and acts of God, random situations over which management has no control. For example, an unexpected earthquake could be so severe and widespread that it could financially wipe out a property and life insurance company in spite of the company's adherence to sound policies on risk diversification. In this context, the insurance company's moral stock would suffer measureably.

It is important that the firm continues to maintain ethical conduct in ways that it can control, e.g., presenting honest product promotions, producing safe products, honoring employee agreements to the fullest and so forth. In this sense, it will use outflows of resources to establish *stocks* of morality in order to encourage various publics to hold the firm in trust.

This would result in compensating inflows of revenues, some of which are due to the firm's moral creditability.

In summary, tying the moral growth idea to the *flow* concept can lead to the development of accounting techniques that would be useful to manage resource infusion in order to reach desired levels of morality. The potential also is there to assess the resulting response or benefits due to the firm's moral development. The concept of *stocks* also can be an integral part of analyzing moral climate at differing points in time. Key to using these two concepts, *flows* and *stocks*, is the resolve of management as to how to advance the firm's moral climate. By building on these concepts, differing strategies for establishing moral improvement can be evaluated. To this end, major decision makers in the firm can purposefully direct the organization's resources to gain a beneficial reputation due to its moral behavior. Thus, the firm may be able to consider that portion of its *goodwill* value attributed to its moral behavior not only when the firm is sold, but also at periodic intervals in the accounting cycle.

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