Chapter 3

Ethics and Finance

One Bad Apple...

PLEASE NOTE: This book is currently in draft form; material is not final.

The business profession has certainly had its share of scandals over the years, and finance in particular has had more than its fair share of the culprits. Given the importance of trust when dealing with matters of money, finance professionals should realise more than most the importance of integrity and reputation. But, more importantly, we should all strive for a higher ideal: to do what is right and just.

Every human that has developed the ability to reason (that is, not acting solely on instinct) has had to make ethical judgments. Debate about what is ethical is not a new topic (many important writings that are still studied today are thousands of years old). It would be impossible for us to definitively explore all of ethics in one book or one course, let alone one chapter, and yet we must, for ethical dilemmas abound for financial managers. To teach the tools of finance without any discussion about ethical use would be negligent (and unethical!).

3.1 Ethics Foundations

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LEARNING OBJECTIVES

1. Define and discuss a working concept of ethics.
2. Describe the four main categories of approaches to ethics.

What is **ethics**[1]? For our purposes, we define it as a system for evaluating whether an action is right or wrong. For example, consider this following famous thought experiment:

A trolley car is hurtling out-of-control down a track where there are 5 workers ahead. You are standing by a switch that can divert the car onto a side track, where only 1 worker is currently. If you do nothing, the 5 workers will be killed, and if you throw the switch, the 1 worker will be killed (but the 5 will be spared). There is no time to warn the workers or take any other action. Should you throw the switch or not?

Asking this question in a group of individuals is bound to start some (perhaps intense) discussion about whether throwing or not throwing the switch is the right choice. In an ideal world, we would each embrace an ethical framework within which we can evaluate this situation.

There are four main categories of approaches to ethics:

1. Outcome based (consequentialism): the possible outcomes (consequences) of actions are determined, and the most desirable of the outcomes chosen.
2. Universal rules (deontology): the “duty” of the actor is to abide by a governing set of rules.
3. Character based (virtue ethics): how an individual’s actions reflect upon their identity and moral standing drives what is proper.
4. Social norms (pragmatic ethics): behaving in ways acceptable to the bulk of society. Sometimes characterized as, “What would be the

1. A system for evaluating whether an action is right or wrong.

reaction if this action was on the front page of the Wall Street Journal?"

To contrast these approaches, consider a friend who has received a terrible haircut asking, "Do you like it?" An outcome based view might support lying, since telling the truth would result in the friend having hurt feelings. Another outcome might be that the truth would make the friend angry, and they might retaliate. Or perhaps telling the truth might convince the friend to visit a different barber.

Instead, one might feel that lying is always wrong, no matter the outcome. Or there might be more complex rules dictating exactly when lying is appropriate.

The third case involves considering the virtue of honesty and the virtue of charity of one's neighbor. The character of an ideal human must have some balance (neither deficiency nor excess) of these virtues.

Another consideration might be, "What is the socially acceptable thing to do?" If the norm is to lie when someone has received a bad haircut, this might be a guide that can be used to determine proper behavior. It might not be acceptable to lie under oath in a court of law, but society may accept a certain amount of dishonesty.

Within these categories, there are many systems which can be considered, and scholars have debated the merits of each over the centuries. It is the recommendation of the authors, however, that finance managers give some thought to ethics **before** encountering dilemmas in the workplace; otherwise, it is more likely that one is influenced to pick an ethical system to justify a desired action, when the causality should flow the opposite direction.

So Which Ethical System Should I Choose?

We can't tell you what system will work for you. We would argue that it is each person's responsibility as a human being to think about this very seriously, and try to arrive at a workable system. There are many books dedicated to thinking about ethics and entire fields of philosophy that discuss these issues.

We can say that we subscribe to a virtue ethics system, and we believe that surrounding oneself with mentors and colleagues that are paragons of virtue is the best way to learn how to act.

Legal vs. Ethical

Note that "legal" and "ethical" are not necessarily the same thing. Most ethical systems include following just laws (since they arise from a social contract), but can allow for the violation of laws that are unjust (the civil disobedience of Gahndi and Rosa Parks are some canonical examples). And, in many ethical systems, the fact that something is permitted by law does not necessarily mean that it is ethical to engage in the behavior.

Additionally, many professions include self-governance or designations that require adherence to a set of ethical guidelines or a code of conduct. For example, the CFA Institute maintains a "Code of Ethics & Standards of Professional Conduct" that members with a CFA designation are obliged to uphold.

KEY TAKEAWAYS

- Ethics are a framework to determine what is right from what is wrong.
- Legal ≠ Ethical

EXERCISES

1. You are standing on a bridge. You see a runaway trolley car hurtling toward 5 workers on the tracks who will be killed if the trolley isn't stopped. Also on the bridge is a fat man who is large enough to stop the car if he is pushed onto the track; he does not see the trolley, and there isn't enough time to get his attention. You yourself do not weigh enough to stop the car. Should you push the man onto the tracks?
2. Justify an answer to the following question using reasoning from each of the four main categories of ethical frameworks: If slavery were still legal, should you own slaves?
3. What does cheating on an assignment imply about the character of an individual?

3.2 Ethics in Finance

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LEARNING OBJECTIVES

1. Explain the concept of fiduciary duty.
2. Discuss examples of ethical issues that arise in finance.

As those who are trained in finance are often in charge of other people's money, it is important to understand the concept of **fiduciary duty**[2], which entails putting another's interests (especially financial) before personal interests. The other party (the "principal") is typically at a disadvantage, either in access to information or experience, to the fiduciary, and thus relies upon the good faith of the fiduciary. There are legal definitions of when fiduciary duty exists in the relationship; there exist cases, however, where there is no legal burden but do invlove an ethical burden.

An example: a trader is told that her client would like to sell shares of stock ABC. The client's order would depress the stock price. It would be a breach of fiduciary duty for the trader to liquidate her position before executing the client's order (this is also called "front running").

Consider the possibility of adopting an accounting strategy that would minimize tax payments. On the one hand, this will increase profits for shareholders, but it will also reduce the amount of taxes paid to the government. Does the company have a responsibility to pay taxes to the government, and if so, does it only extend to the letter of the law?

Another scenario involves a company in distress selling off valuable assets to make interest payments to bondholders. A financial manager has a responsibility to pay the bondholders what they are due, while a duty to the shareholders to not cripple the ability of the company to function as a going concern.

2. The requirement to put another's interests (especially financial) before personal interests.

In each of these cases, the interests of one party conflict with another's, and a financial manager will have to determine how to evaluate and resolve the issue. While there can be legal guidance (especially in the case of fiduciary duty), often it will be up to the manager to make the choice he or she deems appropriate.

KEY TAKEAWAYS

- Fiduciary duty can obligate a manager to put another's interests ahead of one's own.
- While numbers are important, it is equally important to think about context and what lies beyond.

EXERCISE

1. Mike is paid to advise his clients on how to invest their money. One day, he is reviewing the financial statements for a publicly traded company, and believes the company is poised to gain significantly in value. If Mike would like to invest his own money into the company, might he have an obligation to disclose his discovery to his clients first?

3.3 Ethics in Management

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LEARNING OBJECTIVES

1. Explain the agency problem.
2. Describe the stakeholder relationship and enumerate key stakeholders.

Similar to fiduciary duty is the concept of **agency**[3]: a relationship in which one party (the agent) is expected to act on behalf of another party (the principal). A company's management, for example, is expected to act on behalf of the board of trustees, who in turn act on behalf of the shareholders.

Unfortunately, there are many documented cases of the **agency problem**[4], where an agent has incentives to place personal interest over the principal's. One solution is to try to align the incentives of the agent and principal; performance bonuses and stock grants are two common ways to reward employees directly for creating value for shareholders.

Arguably, this relationship extends further. Each employee has a responsibility to diligently work and fulfill the employment agreement. If a conflict of interest arises, the employee should put personal interests aside or terminate the employment arrangement in a fair manner. Management, however, has a responsibility to the employees as **stakeholders**[5] (parties affected by the operations of the company) to balance their interests when making decisions. Many decisions in management involve tradeoffs among stakeholders (which include shareholders) which can rarely be simplified to numbers or a simple good/bad analysis.

Opinions differ on which groups should be considered stakeholders and how their claims should be weighed against one another. The narrowest view endorses maximizing shareholder profit as the dominating factor and only considers stakeholders as far as they can affect profit. For example, a subscriber to this view would choose to protect customers only if they thought doing so would ultimately positively contribute to the wealth of the stockholder. A broader view would

3. A relationship in which one party (the agent) is expected to act on behalf of another party (the principal).

4. A situation where an agent has incentives to place personal interest over the principal's.

5. Parties affected by the operations of the company.

include employees, suppliers, customers, investors, communities (and their governments) where the business operates, etc. Even competitors can be considered stakeholders!

In dealing with the balance between stakeholders, we suggest following one very important guideline: that human dignity is paramount. No manager has the right to consider themselves superior to their employees, suppliers, customers, etc. Treating people as a means to an end cannot ultimately be good for business. This might mean considering the rights of customers to use and resell a product or the rights of employees to a just wage for their work. Of course, in more extreme cases, it can mean considering the effects of addictive substances or even slave labor or human trafficking.

Beyond this principle, there is much room for debate about the proper balance of stakeholder concerns. Businesses are very complex, and a comprehensive list of guidelines could not possible cover every situation a manager will experience in his or her career. This is why it is so important to have managers who are willing and able to exercise their own ethical judgment!

KEY TAKEAWAYS

- One solution to the agency problem is to align incentives of the agent with the incentives of the principal.
- Stakeholders can include employees, customers, suppliers, investors, communities (and their governments), and potentially even competitors!
- Maintaining human dignity should always factor into a management decision.

EXERCISES

1. Supplier ABC has 90% of its output purchased by Company DEF. How might ABC have influence over DEF? How might DEF have influence over ABC? Is ABC a stakeholder of DEF, or is DEF a stakeholder of ABC?
2. A CEO uses company funds to purchase a jet that the CEO will almost exclusively use. How might this be against shareholder desires? How might this be in-line with shareholder desires?
3. Company GHI has developed a drug that causes addiction with painful withdrawal symptoms. Selling the drug is projected to double GHI’s profits, and it would be legal to do so. What other factors might convince GHI to sell the drug? What other factors might convince GHI to not sell the drug?

3.4 International Considerations

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LEARNING OBJECTIVE

1. Discuss how globalization can cause ethical conflicts.

As companies extend their reach across internation boundaries, ethical issues have taken a more prominent position in discourse about the benefit of globalization. Nowhere can the legal vs. ethical divide be more pronounced than when considering international prospects, for what is legal in one jurisdiciton might be illegal in another. As different cultures attempt to work together, different values can emerge on topics such as: fair wages, working hours, child labor, environmental impact, facilitating payments, discrimination in hiring or customer base, etc. Futhermore, companies might make decisions upon where to locate their workforce based upon taxation, labor costs, or regulations.

Being sensitive to cultural differences is a good skill to foster, as attempting to understand the viewpoint of another party can allow for greater collaboration and increased opportunities. Being open to new views and ideas, however, is very different from accepting everything as relative. Many an executive has tried to explain away unethical behavior as "that's just the way they do business there." While this might be a completely true statement, this fact alone does not give a company justification for violating ethical principles. Another common trope is "if we left, another company would come in that is even worse." Choosing the best from among bad options is one thing, whereas it is very hard to support a decision on the grounds of merely being "less unethical".

KEY TAKEAWAYS

- Globalization creates new ethical considerations.
- Cultural plays a role in ethical financial decisions.

EXERCISES

1. Relocating to a key factory to another country will allow a company to reduce labor costs, allowing for greater profits and a lower cost for customers. Discuss the impact on current employees, potential employees in the new country, and other stakeholders.
2. A government official says that company ABC's paperwork will be approved, but that it would probably take six weeks to process. With a $1,000 payment, he can see that it is done by the end of the week. The extra five weeks of productivity is worth at least $10,000 to the bottom line of ABC. What are some of the ethical considerations of this arrangement?
3. Company DEF has a factory located in country GHI. The government of GHI has just declared that one of the byproducts that the factory emits into the local water table is now illegal. The factory requires a $10 million refit to eliminate the byproduct. As an alternative, the factory could be relocated to a neighboring country for $1 million, where the byproduct is not illegal. What are some of the ethical considerations of this situation?

3.5 The Bigger Picture

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LEARNING OBJECTIVE

1. Explain how decisions have both financial and ethical considerations.

Financial problems often have quantifiable components (such as maximizing return, revenues, or profits, or minimizing expenses or risk) and calculating these accurately is certainly important to the decision making process. Impact upon the "bottom line" is a key consideration, but it is not the only consideration; relying upon one or two numbers to justify a business decision is usually too narrow in scope. Throughout this book, many of our exercises are indeed simplifications, designed to allow a student to focus on one particular aspect of a financial problem. But we encourage students to think beyond the problems as presented and consider how they might appear in a "real world" situation. Discussion with colleagues and instructors can help to illustrate how the techniques we present might be part of a larger management decision with answers that are not as clear cut.

Since ethical considerations pervade everything we do, each following chapter will have a section in "The Bigger Picture" devoted to ethics. While we can in no way be exhaustive in addressing ethical issues, our hope is to, at a minimum, begin the discussion about what is right and just concerning the financial topics we present.

KEY TAKEAWAY

- Even simple decisions can have far reaching ethical implications.

EXERCISE

1. Your friend wants a stick of gum. The pack of gum cost you $1.50, and there are 6 sticks in the pack. How much should you charge your friend? Try to answer this question beyond what is the “textbook” answer!

3.6 End-of-Chapter Exercises

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End-of-Chapter Problems

1. A trolley car is hurtling out-of-control down a track where there are 5 workers ahead. You are standing by a switch that can divert the car onto a side track, where only 1 worker is currently, but that worker is your best friend. If you do nothing, the 5 workers will be killed, and if you throw the switch, your friend will be killed (but the 5 will be spared). There is no time to warn the workers or take any other action. Should you throw the switch or not? Does your answer change if there are 50 workers ahead? 500 workers? Does your answer change if the 1 worker is not just your friend, but is your mother? What kind of ethical system are you using to make these decisions?
2. Justify an answer to the following question using reasoning from each of the four main categories of ethical frameworks: is underage drinking ethical?
3. What does the phrase, "He would sell his own mother!" imply about the character of an individual?
4. Jill has placed an ad to sell her used car. She knows that there is a defect with the engine that needs $300 worth of parts to fix, but is unobservable to an inexpert eye. Jack arrives and says he like to purchase the car for Jill's advertised price. What ethical considerations should Jill have?
5. Buying a new machine will increase the quality of company ABC's product. It will also require less labor, so that one worker will no longer be needed. The savings from the worker's salary will pay for the machine. What are the ethical implications of this decision?
6. Upon a recent inspection, it was found that the foreign factory for company XYZ is employing child labor. Using child labor for this work is legal in the foreign country, but illegal in the home company. Furthermore, when the children (and their parents) are asked if they prefer to do the work, the all agreed that they without the factory, they could not afford good food and new clothes. What are some of the ethical considerations of this discovery?