**TRAINING IN FINANCIAL AND BUSINESS MANAGEMENT FOR ROAD CONTRACTORS**

**MODULE FOUR: SESSION SIX PARTICIPANTS’ NOTES**

**ETHICAL ISSUES IN FINANCIAL MANAGEMENT**

**1.0 Introduction**

Ethics in general is concerned with human behavior that is acceptable or "right" and that is not acceptable or "wrong" based on conventional morality. General ethical norms encompass truthfulness, honesty, integrity, respect for others, fairness, and justice. They relate to all aspects of life, including business and finance. Financial ethics is, therefore, a subset of general ethics.

Ethical norms are essential for maintaining stability and harmony in social life, where people interact with one another. Recognition of others' needs and aspirations, fairness, and cooperative efforts to deal with common issues are, for example, aspects of social behavior that contribute to social stability. In the process of social evolution, we have developed not only an instinct to care for ourselves but also a conscience to care for others. There may arise situations in which the need to care for ourselves runs into conflict with the need to care for others. In such situations, ethical norms are needed to guide our behavior.

*Ethics represents the attempt to resolve the conflict between selfishness and selflessness; between our material needs and our conscience*

Ethical dilemmas and ethical violations in finance can be attributed to an inconsistency in the conceptual framework of modern financial-economic theory and the widespread use of a principal-agent model of relationship in financial transactions. The financial-economic theory that underlies the modern capitalist system is based on the rational-maximizer paradigm, which holds that individuals are self-seeking (egoistic) and that they behave rationally when they seek to maximize their own interests. The principal-agent model of relationships refers to an arrangement whereby one party, acting as an agent for another, carries out certain functions on behalf of that other. Such arrangements are an integral part of the modern economic and financial system, and it is difficult to imagine it functioning without them.

* 1. **Why Ethics Matter in Financial Management?**

The list of disgraced – and convicted – perpetrators of financial malfeasance has continued to grow since the dawn of the new millennium. A lack of ethical behavior has led to catastrophe for several companies. Beyond the legal consequences, there are financial implications that follow a decision to act unethically.

Accounting provides the technical data and forecasting information that executives base their decisions upon. That is not to say that all financial scandals are committed by accountants, but the way in which finances are represented has led to the conviction of some of the worst offenders in history.

Corporate financial decisions are a result of a systemic process of analysis, discussion and selection. Steps include generating alternatives, evaluating outcomes, verifying decisions and communicating the result. Because these deliberate steps are taken, trust is built; this trust leads to confidence in the company. If unethical behavior is discovered, then that trust often erodes quickly.

So how does a lack of ethics impact a company’s operations? There are five key stakeholders that are typically affected when financial fraud is uncovered:

1. Lenders – Institutional lenders increase risk assignment due to fraudulent activity. This leads to higher borrowing costs (if you can obtain financing).
2. Investors – Confidence in the company’s performance takes a hit because investors cannot trust the financial reporting that is distributed.
3. Peers – Partners will look elsewhere for business relationships if they cannot trust the company’s management; competitors take advantage of bad news in order to gain a stronger foothold in the market.
4. Employees – Workers’ morale slips following an announcement of unethical behavior. Loss of quality employees can lead to further operational upheaval.
5. Public – The Company’s image will forever be tarnished, even if there is a turnaround under new management. Often a rebranding campaign must take place.

**1.2 Ethics in Financial management**

**Non- financial objectives**

The goal of maximizing shareholder wealth implies that shareholders are the only stakeholders of company. In fact stakeholders of a company include employees, customers, suppliers and the wider community. The formulation of the financial policy of the firm takes into account the interests of the shareholders as a stakeholder group and the formulation of non- financial objectives addresses the concerns of other stakeholders. We will discuss the measures that companies adopt in order to address issues related to **sustainability and environmental reporting.**

Here we provide some other examples of non –financial objectives. Note that these non-financial objectives, could potentially limit the achievement of financial objectives.

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| Non-financial objectives | |
| Ethical considerations | **Actions and strategies** |
| Welfare of Employees | Competitive wages and salaries, comfortable and safe working conditions, good training and career development. |
| Welfare of management | High salaries, company cars, perk. |
| Welfare of society | Concern for environment |
| Provision of service to minimum standard | For example regulations affecting utility ( water, electricity providers) |
| Responsibilities to customers | Providing quality products or services, fair dealing. |
| Responsibilities to supplies | Not exploiting power as buyer |
| Leadership in research and development | Failure to innovate may have adverse long-term financial consequences. |

Most of these non-financial objectives reflect an **ethical dimension** of business activity.

**1.3 Ethical dimensions in business**

Businesses play an important role in the economic and social life of nation. They provide **employment, tax revenues** and have been responsible through **research** and **development** for some for some of the greatest technological breakthroughs which have changed our everyday life. The **downside** of this **dominant role is abuse of power** in the market place**, disregard for the environment**, irresponsible use of **depletable** **resources**, adverse effect on local culture and customs. Companies like Coca Cola, Imperial Tobacco and Mc Donald’s have had an impact on developing countries that transcended the economic sphere and affected dietary habits and ways of life.

Given the power that companies exercise how do we measure their impact on society? How do we assess their behavior against some ethical norm as opposed to mere financial norms? The answer to this question is provided by the development of **business ethics**, as a branch of **applied morality** that deals specifically with the behavior of firms and the norms they should follow so that their behavior is judged as ethical.

It should be stressed that **business ethics** does not invoke a universally acceptable framework of principles that all companies should adhere to. Hence the requirement for a corporate governance framework that would ensure a minimum degree of **ethical commitment** by firms became apparent.

Ethical considerations are sometimes easy to be incorporated into the policy of a company. For example, during the apartheid years many companies were boycotting South Africa, without any governmental coercion. In this case the ethical aspect was clear and easily identifiable. However, for a multinational company in the developing country not to ? wages to its employees that wound render a project uneconomical, may not be seen as unethical, as the employees of that country may have remained unemployed without the multinational company’s presence.

1.4 **Ethical aspects and functional areas of the firm**

**Business ethics** should govern the conduct of corporate policy in all functional areas of a company such as;

* Human resources management
* Marketing
* Market behavior
* Product development.

**Maximizing the wealth of the shareholders** generally implies maximizing profits consistent with long-term stability. It is often found that short-term gains must be sacrificed in the interests of the company’s long-term prospects. In the context of this overall objective of financial management, there are five main types of decisions facing financial managers;

* Investment decisions
* Financing decisions
* Dividend decisions.
* Financial planning and control decisions.
* Risk management decisions.

In practice, these areas are interconnected and should not be viewed in isolation. An equally important function of the financial manager is to **communicate the financial policy and corporate goals to internal and external stakeholders.**

**1.5 Human resources management**

Employees in modern corporations are not simply a factor of production which is used in a production process. Employees as human beings have feelings and are entitled to be treated by their employers with respect and dignity. In most advanced countries there are employment laws that determine the **rights** of employees and provide protection against the abuses of their employers.

**Ethical problems** arise when there is a conflict between the financial objectives of the firm and the rights of the employees. These ethical problems arise in relation minimum wages, and discrimination.

**Minimum wage**

Companies are obliged to pay their employees at least the minimum wage. However, when multinational companies operate in countries where there are no minimum wage requirements then the companies may try to take advantage of the lack of protection and offer low wages. Business ethics wound require that companies should not exploit workers and pay lower than the warranted wages.

**Discrimination**

Discrimination on the basis of **race, gender, age, marital status, disability or nationality** is prohibited in most advanced economies, through **equal opportunity legislation**. However companies may have the power in some instances to circumvent many of the provisions. Companies for example may be able to discriminate against black applicants for certain positions for which they may feel that they are appropriate.

Employers may also wish to discriminate against mothers in certain jobs for which overtime is required. In other circumstances a company may want to restrict applicants from certain ethnic background when they deal with people of similar ethnic backgrounds. In all the cases of potential discrimination the company wishing to behave ethically should be aware of the risk of breaking the rules.

**1.6 Marketing**

**Marketing decisions** by the firm are also very important in terms of the impact on firm performance. Marketing is one of the main ways of communicating with its customers. This communication should be **truthful** and sensitive to the **social** and **cultural impact** on society. The marketing strategy should not target vulnerable groups, create artificial wants or reinforce consumerism. It should also avoid creating stereotypes of creating insecurity and dissatisfaction.

**1.7 Market behavior**

Companies should not take advantages of their **dominant positions** in the market to **exploit suppliers** or **customers.** Ethical behavior in this context refers to the exercise of restraint in their pricing policies. Companies which are dominant in the product market and enjoy monopolistic power may charge a price which will result in abnormally high profits. For example a water company may charge high prices for water in order to increase its profits because the remuneration of managers may be linked to profitability. Similarly a company which in the input markets may be able to pay too low a price to their suppliers. For example in many developing countries multinational companies are the only buyers of raw materials and they determine the price they pay to their suppliers.

**1.8 The elements of an ethical financial policy**

Ethical policy can be implemented through measures that ensure that the company takes into account the concerns of its stake holders.

**The ethical framework**

The company should develop an ethical corporate philosophy and should make the enhancement of corporate governance as one of its most important management issues. The aim is to have customers and society, as well as shareholders and investors, place even greater trust in the company and to ensure that the company is one that society wants to exist. The ethical framework should be developed as part of the overall company’s social responsibility which according to Carroll includes

1. Economic responsibility
2. Legal responsibility
3. Ethical responsibility
4. Philanthropic responsibility

The four responsibilities have been classified in terms of priority for the firm. Economic responsibility is the first and philanthropic responsibility the last. Carroll’s framework is considered a useful way of integrating the various aspects of a company’s activities and helpful as a means for management to test social responsibility targets within an organization.

The only problem with the framework is the lack of an explicit mechanism for addressing conflicting corporate responsibilities, when for example legal and regulatory compliance may limit the economic return that a company can achieve.

**Economic responsibility**

The first responsibility of a company is to its shareholders. Shareholders have invested their money in the company and require a return. The company has therefore a responsibility to manage the funds of outside investors in such a way that the required return is generated. The main aspects of the economic responsibility include the various decisions that the financial manager is responsible for, such as financing, investment, risk management and dividend.

**Legal responsibility**

Companies operate within a legal framework as defined by company law, the various accounting and environmental standards, labour law etc. it is a duty of the company to comply with all the legal and regulatory provisions, and to ensure that employees are aware of this policy. As we have already said, ethical responsibilities arise in situations where there is no explicit legal or regulatory provision and the company needs to exercise its judgment as to what is right and fair.

**Ethical responsibility**

Ethical responsibilities arise not as a result of legal requirements but as a result of a moral imperative for companies to operate in an ethical and fair manner. We have already discussed examples where issues of business ethics arise. How does a company ensure that an ethical approach to various aspects of a company’s activities is adopted? The following are deemed to be the elements of a business ethics management in a European or US corporation.

1. **Mission or value statement**. A corporation has a mission statement in which some social goal is included.
2. **Codes of ethics** to be followed by the employees and which specify their attitude and response to ethical dilemmas. The code of ethics should reflect corporate values but it should also incorporate professional codes of ethics, which individual employees as members of professional bodies need to observe.
3. **Reporting /advice channels** for employees to notify unethical behavior or to seek advice on specific situations.
4. **Ethics managers,** officers and committees to coordinate or assume responsibility for the implementation of ethics in the corporation.
5. **Ethics consultants** should be consulted by corporations on specific issues of business ethics on which the corporation needs advise as to the appropriate course of action of policy formulation.
6. **Ethics education and training** should be provided to the managers and employees of a corporation to ensure that ethical problems are recognized and dealt with according to the ethics code of the corporation.
7. **Auditing, accounting and reporting** are necessary aspects of a business ethics programme since the corporation needs to be able to measure and report its economic and social impact to its stake holders.

**4.5 Philanthropic responsibility**

Philanthropy is the last of the responsibilities of a company and includes all those actions that the company needs to take in order to improve the life of its employees, to contribute to the local community and to make a difference to society as a whole. Philanthropic activities include charitable donations, the provision of recreation facilities to employees, the support to educational institution, the sponsoring of athletic and cultural events and so on.