

# ETHICAL ISSUES IN BUSINESS AND FINANCE

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*The large-scale violation of ethics in the fields of business and finance that precipitated in the form of numerous frauds and scams in India in recent years has prompted the scholars and intelligentsia to rethink over the entire issue of ethical behaviour in business, trade and commerce. Evidently, in order to altogether root out corruption and unethical conduct from the society, it is crucial to identify its genesis. It is against this backdrop that the present paper delves deeper into the ethical issues involved in investor protection, accounting and auditing, corporate governance and banking & finance. In the preparation of this paper, the author has immensely benefited from the views expressed by various scholars at a two-day national seminar on ethical issues in business and finance which was jointly organised by Shri Ram College of Commerce, Delhi University and the Institute of Chartered Accountants of India at Vigyan Bhawan, New Delhi on November 21-22, 1998.*

## INTRODUCTION

Despite a long-standing tradition of ethical discourse by our sages since ancient times, India is now counted among the most corrupt nations of the world. This moral and ethical downfall in the contemporary Indian society is essentially attributable to the misplaced belief on the part of the people at large that even ill gotten money acquires legitimacy by being placed at the feet of God and holy men in temples.

In the arena of trade and commerce, the domestic market in India has been essentially a *seller's market* and thus unscrupulous businessmen encouraged by equally unscrupulous consultants easily managed to exploit the public. Their only

moral, if there was any, is to make money whatever be the consequences for the society. Thus they are neither bothered about the quality of their product nor about reasonable prices being charged from their customers. In addition, even finance companies tend to cheat gullible investors and then vanish in thin air. Any number of laws to control business and regulate financial institutions, howsoever stringent, will prove to be futile till we have ethics in business and finance.

In fact, even some lawyers and accountants join hands with organised criminal syndicates and thereby help them in their numerous nefarious activities such as transforming their black money into white by

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advising them on safe channels for the purpose. The only plausible remedy for this problem is to break the nexus between politicians, criminals, businessmen and the bureaucrats. It is actually in this respect that the young generation of accountants, professionals and business consultants has to play an active and dominant role in curing the ills of the present day Indian society.

It is unfortunate that under the so-called *loyal agents argument*, even those who follow a highly ethical behaviour in their personal lives, often compromise with their ethics in their role as business managers. What these professionals and managers fail to realise is that the loyalty towards ones' employer does not call for mortgaging ones' conscience. One must be honest to oneself and ones' country. There is no denying the significance of *Product, People and Profit* in any business situation. But profit in this context should not be misinterpreted as implying any type of exploitation. The cost of unethical behaviour for the society as a whole is practically unimaginable and it is typically the people belonging to the lowest strata of the society who have to suffer the most. Thus managers, whether acting as agents or owners, must always take business decisions that are in line with their personal ethical values. They would then be able to fruitfully contribute towards building a good and ethical corporate culture.

The principle of *Management by Objectives* which is gaining popularity in modern business situations has also contributed significantly towards the violation of ethical behaviour. Evidently, when a business organisation is solely committed to the attainment of its ends irrespective of the means employed for the same, ethics and moral values are the major casualty in the

process. To put it simply, *the tendency to make a fast buck through short cuts and by hook or crook* has led to the ethical and moral downfall as observed in the fields of contemporary business and finance.

In the pursuit of success and motivated by greed, people often accord little significance to ethical and moral values in their lives. What is most surprising is that dictated by a jealous attitude towards others or guided by an inner urge to acquire something more than one actually needs, one often tends to justify one's greed and basic human instinct of coveting for what one does not possess. It must, however, be realised that these unethical decisions or actions on the part of a business firm that are essentially governed by the compulsions and constraints of a highly competitive and materialistic society can at best yield benefits only in the short-term. But in the long-term, all such unscrupulous and immoral practices invariably lead an organisation towards the path of destruction and disaster. It must be noted that even in today's pragmatic society, *Good Ethics is Good Business*. The ethical behaviour of a business corporation gets reflected in its respect for the law of the land, transparency and truthfulness in decision making and its consciousness about social responsibilities.

Yet we typically find that instances of such a violation of ethical behaviour are generally reported now and then in the spheres of banking, financial institutions, accounting, business, industry, trade and the corporate sector etc. Evidently, when an organisation deals with public funds, any lack of integrity on its part is bound to ruin its reputation in the long-term. The purpose of the present paper is to delve deeper into all such ethical issues involved in investor protection,

accounting & auditing, corporate governance and banking & finance.

## INVESTOR'S RIGHT TO ETHICAL BEHAVIOUR

The issue of investor protection has gained prominence in recent years especially since the rise and fall of investors' fortunes in the 1990s in Indian stock markets wherein the retail investors were induced to practically desert the capital markets in India. It was almost a win and then lose situation in which some investors made good fortunes while other suffered heavy losses. When it was a boom period, not only the government but also the international credit rating agencies and the media praised the Indian policies. But once the bubble burst with the *Bank Scam*, investor's rights protection became the buzzword and there was a lot of hue and cry about it. In view of this, the Securities and Exchange Board of India (SEBI) was entrusted with the task of regulating it. As the SEBI too was then in a learning phase, the end result was only the issuance of some guidelines in bits and pieces.

In fact, the crucial question relates to the extent to which the investors actually need and deserve protection when they are deliberately going in for a risky venture to reap high gains in a short span of time. If an investor does not get the expected yield, only he is to be blamed for that. Nevertheless, *an investor, at least a retail investor has the full right to get an environment free of frauds so that he does not unnecessarily become a victim of it.*

Ethics and ethical behaviour is a contentious issue since the interests of stakeholders, stockholders, financial institutions, government, business and those of people at large are more often than not mutually

conflicting. Thus it becomes pertinent to first decide on whose interests are to be protected or given precedence over others' interests. Here one way out to protect investors' interests in through *investor's education* so that even an ordinary investor living in, say, some remote village or corner of India could have access to relevant information and be able to take judicious and prudent financial decisions. In this connection, it becomes desirable to promote the concept and role of Non-Government Organisations (NGOs). Likewise, the business and trade associations too could come forward to *educate investors regarding the kind of games that business and financial institutions could play with the hard earned money of the investors.* It has often been observed that the more is the information provided to investors, the more confused they get. In order to overcome this, it is imperative to train and educate investors in such a manner that they are not only able to properly interpret the balance sheets and profit and loss accounts of business companies, but are also in a position to read between the lines!

Alongside, a better corporate governance and integrity of promoters that could conform to ethical standards is also urgently called for. Effective surveillance of the market and exemplary punishment to the guilty would go a long way in protecting the rights of investors. Towards this end, media must play an active role running on ethical lines. Nevertheless, there is no need for being pessimistic on this count since *transitions come with turbulence. More is turbulence, more mature is the result of the concerned turbulence.*

In fact, ethical issues must be discussed in a much wider perspective than merely

addressing to the protection of investor's rights. When it comes to ethical behaviour, one must look beyond mere investor protection. Ethics in a broader sense connote a socially acceptable behaviour and thus apart from protecting the interests of shareholders, also calls for the protection of rights of all other stakeholders in a company. Investors can survive only when an environment of excellent industrial relations prevails in business organisations which should in addition remain committed to providing the best possible consumer satisfaction too. We could look at the entire issue in terms of an *agent-principal relationship wherein the investors have a right to expect ethical behaviour from those to whom they have entrusted their funds*. Since the agent to whom the investor entrusts his funds works as a trustee acting within the parameters he is supposed to act, the investors should at least have the right to monitor him periodically, to know as to where and how their money is invested etc. In this context, Dunfee (1998) points out that ethics is the fundamental basis for the industry. For, in the markets where trillions of dollars are transferred on trust, it is ethical capital that ultimately supports financial services.

It must nevertheless be conceded that just like in a small business, return is expected to be commensurate with the risk. Even an investor in big business must realise that any possible return would involve some element of risk. Thus before going in for a corporate investment, a potential investor must judge his risk-bearing capacity first so as to evaluate or assess his own skill and capability to go to the capital market. However, retail investors seldom make such an assessment and it is only by burning their fingers, so to say, do they realise the

difference between investing in a fixed deposit and investing in a share.

In any case, as of now there seems to be little motivation on the part of the corporate sector to follow ethical behaviour. What is needed is *to put a higher price on not being ethical by increasing the penalty on the violation of ethical behaviour by the corporate sector*. It must further be pointed out that this endeavour of investor protection would remain unfulfilled till the investors and shareholders themselves come forward to safeguard their interests by exercising their rights and performing their duties. There is practically no external motivation for being ethical and hence no external agency is likely to come to their rescue as a saviour.

Some scholars, however, hold the view that *the market itself rewards ethical behaviour* in the sense that transparency and ethical behaviour become a competitive advantage in the capital market. Not only do the share prices of companies adhering to ethical norms rule high in the market but the companies concerned themselves become strong by following ethical code of conduct to withstand and prevent any possible take over bids. Ethics here essentially imply that *corporate resources are not used to meet personal requirements and power is not abused*. For ensuring this, obviously a change in attitudes is required not only on the part of corporate managers but also on the part of investors at large who have often been observed deserting a company whenever it faces rough weather or experiences a downturn. In other words, a *two-way contract* is needed between the investors and corporate management.

It is noteworthy that transparency and ethical behaviour do not merely call for a compliance of the prevailing law but require

something much beyond that. For instance, a much higher level of reporting to the investors concerning the past, present and future state of the financial health of a company is needed than laid down by law. Once this happens and moral principles and rules of conduct concerning openness, integrity and accountability are followed, it will enhance the ability and legitimacy of the concerned business. In fact, what is required is to have a broader perspective wherein the interests of investors as members of the society at large are protected rather than merely as being investors. All this would require a higher level of disclosures, provision of relevant information in time, honest reporting by companies as investment is essentially an act of faith. In short, *a greater degree of information flow* is a desirable attribute and sharing information with the investors could go a long way in raising their confidence which is a must for the long term viability of the concerned company. Compliance to ethical and moral code of conduct would give a competitive edge to a company thereby attracting more investment from shareholders. It must, however, be realised that *being ethical is a dynamic process that can never rely on maintaining status quo* and the market place is the best place to experience that.

It must further be noted that *Ethics and Business are fully compatible* and it is a misconception to believe that wealth cannot be acquired without being unethical. The ethical and moral crisis in the present-day society bears testimony to the fact that it is actually unethical behaviour in business which leads to the erosion of public confidence thereby precipitating into a vicious cycle of recession. Good ethics and good standards on the part of management

and investors are a must which in turn calls for a change in our mind set that can only be ensured through collective responsibility and action. To put it simply, wealth and value can be simultaneously created via innovation and without resorting to unethical behaviour. A radical change in the whole approach and outlook towards society and business is needed to fructify it in reality.

### ETHICAL ISSUES IN ACCOUNTING AND AUDITING

The ethical issues involved in the spheres of accounting and auditing assume significance in the light of the fact that the companies bill is still pending before the Parliament.

In this connection, it is pertinent to first of all highlight the *Code of Ethics* needed for a professional accountant so as to ensure that potential clients are in a position to engage a chartered or professional accountant of *competence, character and integrity*. In a strict sense, such a code of conduct running on ethical lines calls for four major things viz. *Credibility, Professionalism, high quality of Service and utmost Confidentiality*. A professional accountant should have at his disposal all the requisite knowledge and information and must be well-versed with all the relevant legislations. Further, apart from merely satisfying his clients, a professional accountant must owe a greater responsibility towards the society. At the same time, misconduct such as forgery, material misrepresentation, grabbing the documents of clients, misappropriations of any kind, adoption of coercive methods with banks and other financial institutions etc. should be subjected to the severest of disciplinary

action. This does not, however, provide us with any justification to blame all types of industrial sickness, bank scams and failures of Non-Bank Financial Intermediaries on the chartered accountants and auditors. In fact, the inherent limitations of the process of auditing have led to all kinds of misconceptions about the scope of audit and the efficacy of the auditors. In this context, we must realise that audit is largely persuasive and not conclusive in nature since it is invariably conducted under some particular statute and it is quite conceivable that the relevant provisions within the law might not require the concerned auditor to report on certain issues. Black sheeps are there in any profession and morality being so low in the society as such, the accounting profession is no exception. *The accountant and auditor should not be made a scapegoat for all the ills of the society.*

The fact of the matter is that just like a good citizen, a good corporation is one that not only abides by the law but also possesses good ethics and morals. More specifically, a corporation running on ethical lines will follow such accounting procedures as would effectively present a true and fair picture of the organisation with no scope for window-dressing and 'notorious' accounts so to say. Alongside, a good corporate accounting should also be supplemented by *strong internal audit* since an external auditor coming only once in an year cannot go into the nitty-gritty or intricacies of all the relevant issues. Even quarterly financial statements will not serve much purpose in case they are manipulated with. It is actually with a view to avoiding any possible bungling or deliberate tempering of the relevant accounts that an effective and efficient system of internal auditing in a business organisation is urgently called for.

## ETHICAL ISSUES IN CORPORATE GOVERNANCE

In the context of the ethical issues involved in corporate governance, it may be noted at the very outset that *it takes several centuries to make history, centuries of history to make civilisation and several centuries of civilisation to build culture.* Thus an ethical corporate culture could only be built over a very long period of time. Further, since profit is the driving force behind all corporate activities, business corporations will opt for good and ethical practices if and only if it promises a higher level of profitability to them.

All the issues concerning ethical dimensions of corporate governance have come to the fore fairly recently especially after the coming in of the Cadbury Committee report. Broadly speaking, there are three stakeholders for a company viz. shareholders, employees and the consumers. Since in the annual general meetings, shareholders hardly have a say, their views can only be judged from their behaviour in securities market and stock exchanges. Owing to the lukewarm response from shareholders and retail investors, even the so-called *blue-chip companies* making profits often experience a significant downfall in their share prices. A comparison of the Price-Earning (P.E.) ratios of a few Indian companies with those of Multi-National Corporations reveals that the P.E. ratios are far lower in the case of Indian companies vis-a-vis the MNCs. A lower Price-Earning ratio signifies a lower ability of the concerned company to raise money in the stock market for expansion, diversification etc. This difference in Price-Earning ratio is not explainable solely in terms of profitability since despite earning a relatively high level

of profits in comparison to their multinational counterparts, a number of Indian companies command very low P.E. ratios. The fact of the matter is that the Price-Earning ratio of a business firm largely gets determined on the basis of the way market perceives its management i.e. what are the long-term prospects of the company under consideration which in turn is essentially shaped by how appropriately and ethically is the concerned company being managed. As the secular trends can never be altered through any kind of manipulation, the long-term performance of a company is primarily conditioned by its ethical standards. Hence, what ultimately matters in this respect are standards of morality and ethics followed by a commercial organisation and any wrong doings on its part always get exposed sooner or later. A business establishment adhering to unethical practices is bound to collapse in due course as *the long-term ability of a company to remain competitive is crucially dependent upon good corporate governance.*

In case the management of a business firm indulges in unethical practices like bribing the politicians, bureaucrats, income and excise tax officials or raising false bills under one pretext or the other such as selling scrap or advertising etc., the employees with the organisation concerned come to know about it. Thereby the whole credibility that the management could command with its employees is lost forever. As a result, when it comes to wage-negotiations, the employees invariably resort to *militant trade unionism* so as to extract from the management as many benefits for themselves as are possible. It has often been observed that with the money acquired through fraud and unscrupulous means, the managers of some companies build palatial

houses or go out on holidaying abroad, etc. What all these errant managers fail to realise is that the company they are working with is not their personal property. Further, *by accepting and paying bribes, the management of an organisation tends to lose on its moral authority thereby affecting the motivation of its workers adversely and producing more and more rot in the entire system.*

Likewise, when it comes to the relationship between a business corporation and its consumers, it must be kept in mind that only best performance to the consumers and genuine behaviour on the part of a business firm gets valued *in the market.* Thus, *what is needed on the part of the members of any board of corporate governance is to serve as effective watchdogs rather than conniving with dishonest management or serving merely as their rubber stamps.*

Instead of looking at the inter-company differentials in Price-Earning (P.E.) ratios, however, one could compare average Price-Earning ratios for Indian companies with their levels in foreign countries. Such an analysis reveals that at present, not only cross-sectionally but even intertemporally the P.E. ratios in India are the lowest thereby signifying a lack of confidence of investors in the share market. The most surprising aspect of it is that such a pathetic state of affairs is prevailing since 1995 with no signs of recovery which apparently goes against the conventional wisdom in this respect. To some extent, this paradoxical loss of faith of investors and shareholders in the stock market could be attributed to the ongoing *political uncertainties.* But that alone, perhaps, cannot be a sufficient reason behind it since the resulting instability in exchange rates does not affect the

domestic residents and investors in any direct manner. In the ultimate analysis, we find that this scenario has largely emerged out of a failure on the part of the government of India to suitably address the concerns of individual investors. It is essentially owing to the apathetic attitude of the government that the long-term rate of return on shares in India has fallen below even that on bank deposits, debentures and National Saving Certificates. The callous attitude of the government further gets reflected by the fact that of late, it has even failed to protect and safeguard the interests of bond-holders who by their very nature are generally considered to be more risk-averse than the investors in stock market. In fact, this follows from a tendency on the part of the government to accommodate the guilty as far as possible rather than punishing them. If we let the things continue to function on their own under the wishful thinking that a good corporate culture would eventually evolve, then the shareholders will be, so to say, looted altogether. The only ray of hope for the individual investors lies in a proactive role of the government that ensures that *the boards of corporate governance retain their independence by exercising full control over the management of companies concerned.*

It is noteworthy that law is merely a bench marking for ethical behaviour and *the issue of ethics and morals in business and corporate situations calls for something more than mere compliance of the relevant laws and regulations.*

## **ETHICAL ISSUES IN BANKING AND FINANCE**

A relevant question to be answered in the context of ethical issues involved in banking and finance is that how does this violation

of ethics come about in the spheres of banking and finance despite the existence of an apex central bank viz. the Reserve Bank of India and various other controllers of the financial system in India. On closer examination, we find that the fault lies with certain loopholes in the underlying system itself which are exploited by unscrupulous elements in the society to serve their vested interests. Frauds can also take place due to the connivance of some insiders within an organisation as, for example, happens in the case of all misdealing concerning investment banking or deposit accounts of commercial banks. The main sufferer of all such unethical practices in banking and finance is undoubtedly the public at large. In a way, the tax legal machinery also tends to indirectly promote and perpetuate such unethical behaviour since the guilty often manage to either get scot-free or have to bear only meager penalties and punishment.

As prevention is always better than cure, therefore in recent years, on account of the consumer movement gaining ground coupled with the setting up of offices like *consumer courts and banking ombudsman*, the ethical climate all around has started improving. The need of the hour is to impose strict penalties for unethical behaviour particularly in the context of an increasingly liberalised environment emerging in India.

The exact meaning of what is ethics and what shall constitute an ethical behaviour depends on a host of factors because the behaviour of an individual is closely linked to his basic attitudes and values in life. These values in turn are connected more to human emotions rather than any well-defined set of reasoning or pure logic. In this context, Flory et.al. (1992) observe that



ethical perception of a situation is a complex process, involving at least three dimensions viz. *moral equity, relativism and contractualism*.

Further, empirical studies on the perceptions of bank executives reveal that most managers believe in the relevance of ethical practices for long term success in their business endeavours. However practical realities in the contemporary environment require them to make compromises. As such their view is that ethics and economics do not go together, and resorting to unethical practices was necessary for success in business. Most of those people who progressed in the world did not conform to the principles of morality and ethics in their behaviour.

In view of this, Gupta (1994) contends that financial sector organisations would need to ensure that individuals are not only enabled to develop an 'informed conscience' but also build up courage and fortitude to live by it in the face of ethically complex situations. A necessary condition for this to happen would be the top management's commitment, credibility and willingness to take action on the values espoused by them. They would need to create a cohesive culture around the core values which shape the conduct of business, design of organisational structure, systems for performance appraisal, promotion and other decision making processes, and thus provide a common frame of reference to individuals and groups. Through systematic training and education, it should be possible to develop the personal code or the conscience of managers.

In the arena of banking and finance, a few *ethical issues involved in the allocation of institutional credit in India could also be highlighted*. On ethical and moral grounds,

the Reserve Bank of India has accepted the basic principle that institutional loans will be sanctioned on the basis of the credit worthiness of the purpose for which they are sought rather than the credit worthiness or financial status of the borrower. Yet we typically find that in actual practice, the banks and other financial institutions tend to favour their richer clients to the neglect and detriment of the poorer ones.

In this connection, Gupta (1999) observes that the managers of banks and other financial institutions share a common social background, common social aspirations and social values with the richer and influential sections of the society. This tends to develop a nexus between the two that gets further strengthened by the adoption of certain *unscrupulous and illegitimate* practices by the richer sections. For instance bribing the bank management either directly in cash or indirectly via holding dinners and cocktail parties in five star hotels, presenting expensive gifts to bank managers and even offering cushy and lucrative jobs to the managers of banks and financial institutions after their retirement etc. All these corrupt practices in effect develop an *unethical symbiotic relationship* between bank management and their richer clients. This works to the detriment of the poor and economically weaker sections of the society who are invariably not in a position to offer any kind of direct or indirect gratification for the bank managers.

Further, it is well documented that the incidence of default on the principal amount as also the interest amounts on loans is higher in the case of rich and large borrowers vis-a-vis the poor and small borrowers. This paradoxical observation can only be explained in terms of the

underlying political dynamics. The richer borrowers are pampered to such an extent by their political patrons that despite possessing the capacity to repay, they deliberately choose to remain dishonest and exercise their political influence to get the concerned loans waived-off altogether. Once this happens, the public funds are blocked and cannot be rechannelised towards the poor and deserving sections of the society.

Thus it follows that if the Reserve Bank of India wants to ensure growth with distributive justice, it will not only have to formulate its credit policy on ethical and moral grounds but will also have to ensure that the working of the commercial banks, development banks, co-operative banks and other financial institutions broadly conforms to those very ethical standards laid down by it.

In the ultimate analysis, we find that the need of the hour is to set high standards of personal ethics and morality for ourselves before passing judgments on what others in the society ought to do. That is to say, *disciplining oneself is the most important*

*thing when it comes to the enforcement of ethical and moral values in the society.*

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