Ethical Issues in Finance

Introduction

With the growing economies, trade and the markets; the crimes/ unethical practices have also grown and the subject of corporate ethics has come in the forefront. Horrigan (1987) opine that "the world of modern finance is not a nice place from the ethical point of view" (p. 107). Many Contemporary financial economists view ethics as an obstacle in the fulfilment of objective i.e. profit maximization (Dobson, 1993). Blommestein (2006) highlights that there is insignificant association between ethics and modern economics including finance. The modern financial instrument like derivatives (involving high risk) does not follow ethics or moral values. The financial activities violate the ethical and moral values and it can be attributed to the underlying assumption that the investor is rational (Sifah, 2009). On contrary, Ganguly (2010) believes that people automatically perceive ethics as a system that provides set of principles to distinguish between what is right and what is wrong. Throne (2000) studies the relationship between moral development and descriptive reasoning. The result indicates that accounting students uses moral principles in analysing the accounting problems during ethical dilemma. Wong-on-Wing & Lui (2007) examine the ethical behaviour across culture and find that the Chinese people are more sensitive than Americans. With an increasing trend towards globalization, this cultural difference is a key factor that has augmented the concern for ethics in the organizations. To overcome this problem and have good corporate governance, there must be an entity who works for it. Neilson (2010) states that "If we cannot avoid subsidizing, bailing out and recapitalizing the financial institutions to some extent at the expense of the ordinary people, at a minimum, we need better and stronger enforcement and regulation to protect against the recurring, exponentially negative effects of large, sub prime and often over- leveraging bubbles and bailouts". Even though a separate legal presence and subsistence of the organization has been established by the courts a long ago, yet, the present complex hierarchy of corporate make it a tedious process to find out the real offender who acted on behalf of that legal epitome. Thus, the organizations must follow certain ethics and proper code of conduct for the smooth functioning and long run survival of corporate in the market. Tsalikis (2011) observes that the firms operating ethically perform better than the ones not following the ethics. Anbalagan (2011) highlights that in modern finance, the areas where a greater attention needs to be given to the ethics are Creative accounting, revenue management, financial analysis misleading, the insider trading, securities fraud and manipulation of financial markets. The scams involving MNCs like Satyam, WorldCom, Enron etc. are the result of deceitful accounting. The various unethical practices are money laundering, insider trading, window dressing, utilization of funds for personal benefit etc. To resolve these issues or unethical practices, there is a need to integrate business ethics and financial economic analysis (Fernandez, 2004). Fleming & Schwarz (2009) believes that during ethical dilemma, the organizations should behave with honour. Singh & Kant (2010) focus on the need for timely and effective communication with the stakeholder regarding finances to avoid these unethical practices. Hinde (2007) opine that the ethical behaviour of firms depend upon the awareness about ethical issues to the public/customers. The various measures have been taken by the government across nations to control the corporate lapses and have good governance. In the United States, the Sarbanes-Oxley Act 2002 (SOX) was implemented as well as comprehensive New York Stock Exchange Listing Rules. In the United Kingdom, a Combined Code on Corporate Governance 2003 was established. The Australian authorities implemented CLERP 9 Amendments, 2004 and various Corporate Governance Codes. The government of Singapore amended its Companies Act 2002 and revised its Corporate Governance Code in 2005. The different initiatives have been taken by Indian government and are as follows:

i) New Companies Act – inducing good corporate governance practices through self regulation, responsive legal framework based on shareholders' democracy; disclosure based regime

ii) Amendments to the Acts governing three professional institutes (ICAI/ICSI/ICWAI) with a view to strengthen the disciplinary mechanism and bring transparency

iii) Notification of Accounting Standards with a view to bring the disclosure norms in tune with the international reporting standards

iv) SEBI – Clause 49 – Appointment of IDs, Audit committee, Code of conduct, disclosures of related party transactions, remunerations, compliance of accounting standards, certifications of CEO & CFO, Compliance Certification & Whistle-blower policy (optional)

The other measures like RTI (Right to information) and PIL *(*Public Interest Litigation) are provided by the government to control the unethical practices. The RTI is helping the public in exposing the scams and thus improving the governance of the economy. It is evident that the money held by Indian in the Swiss bank has decreased to one third and is about 1.2 billion francs at the end of 2015 (The Hindu, 2016).
It is apparent that the number of corporate lapses has increased tremendously and they involve huge amount.

Ethical issues and their cases:

i) Money Laundering

Money laundering is one of the significant issues related with finance. Money laundering is a process by which criminals' camouflage the original ownership and control of the earnings of criminal conduct by making the income appear to have derived from a legitimate source.

Case: <u>Kingfisher Airlines</u>

The CBI has registered a money laundering case against Mr. Mallya, his company Kingfisher Airlines and unknown IDBI Bank official. The Enforcement Directorate (ED) provisionally attached movable and immovable assets with market value of Rs.1,411 crore of Mr. Vijay Mallya and United Breweries (Holding) Limited in connection with a money laundering case against him. The attachment has been done as part of investigations into the suspected Rs.900

crore IDBI Bank loan default case. The assets of Vijay Mallaya include bank balance of Rs.34 crore, two flats in Bengaluru and Mumbai, an industrial plot in Chennai etc.

A amounting to Rs.864 crore was sanctioned to the airlines against the collateral security of Kingfisher brand, corporate guarantee of UBHL and personal guarantee of Mr. Mallya. Out of the total amount, Rs.807 crore was unpaid. Despite of weak financials, negative net worth and low credit rating of the company, the corporate loan was sanctioned and disbursed. The loans were cleared in spite of the fact that the company (being a new client) did not satisfy the norms stipulated in the corporate loan policy of the bank. According to the Directorate, Kingfisher Airlines and its officials conspired to get the loan sanctioned without due conscientiousness and the airlines diverted the funds. The loan was sanctioned hurriedly without independent verification of the security provided.

It was found that the airlines allegedly defaulted in repayment of loan from the very beginning causing wrongful loss to IDBI Bank. The funds amounting Rs.423 crore were transferred outside the country as aircraft lease rentals and other expenditures. However, no supporting documents have been furnished to authenticate these claims leading to the conclusion that the part of loan was siphoned off abroad.

To over the problem of money laundering, an act came into existence in 2002 which is further amended in 2012. The Prevention of Money Laundering Act, 2002 is an act which is enacted to prevent money-laundering and to provide for confiscation of property derived from money laundering process. It has three main objectives:

a) To prevent and control money laundering

b) To confiscate and grab the property obtained from the laundered money

c) To deal with any other issue connected with money laundering in India

ii) Insiders' Trading

The other major ethical issue in finance is insiders' trading. Insider trading is a malpractice wherein trading of securities is undertaken by people (insiders) who have access to the information which the public don't have and is vital for making investment decisions. When an insider uses the price sensitive confidential information of the company to buy/sell its shares thereby making a personal profit, he/she commits a crime that have moral as well as immense legal implications.

Case: <u>Maher Kara, a former Citigroup investment banker</u>

A case has been registered against hedge fund managers and other traders. It has been found that Maher Kara, a former Citigroup investment banker who was Salman's brother-in-law, tipped Michael Kara, his brother, about mergers involving clients of citigroups. In turn, Michael Kara tipped Salman and helped him to make $1.19 million trading ahead of deals including a 2007 merger announcement with Biosite Inc.

The SEBI has made the following regulations to put in place a framework for prevention of insider trading in securities and to strengthen the legal framework. The Prohibition of Insider trading Regulation, 2015 orders that there should be "No trading between 20 days prior to Financial Period and closure of second trading day after result announcement".

iii) Window Dressing

It has been observed that window dressing is another significant issue associated with the ethics in finance. It is a form of creative accounting wherein the manipulation of figures is done to flatter the financial position of the business.

Case: Sobha Developers

A South Indian developer named Sobha Developers changed its accounting policy in first quarter of financial year 2009 for revenue recognition, which facilitated the company with revenues being recognised earlier in a project cycle. A press release revealed that if the accounting norms had not been changed, the Profit before tax of the company would have been lower by 20% in the first quarter of 2009. It has also been available that the company has changed its accounting policy for revenue recognition for sale of undivided share of land (group housing) on the basis of certain minimum level of collection of dues from the customer. This has resulted in additional revenue recognition and higher profit before taxes of Rs 32.1 crore and Rs 15 crore respectively during the quarter ended June 30, 2008.

iv) Utilization of funds for personal benefit

The most common ethical issue is the utilization of funds for the personal benefit. The company's assets and funds are for legitimate and authorized business purposes. Misappropriation of Company's assets is a breach of one's duty towards the Company and may be an act of fraud against the Company.

Case: Harshad Mehta Scam

The Indian stock market has come across issues when the investors/brokers use money from the banks for their personal benefit. Harshad Mehta scam is one major example of such issue. Harshad Mehata is named as "Big bull" in the Indian stock market. Harshad Mehta was working with the banks from a long time and had good relations with the senior managers of those banks. He convinced the manager that he was not sure whom we may end sealing the deal with, as he works with multiple banks together and borrowed money from a small bank in the form of cheque in his name. Writing the cheque in favor of the broker was forbidden by law. But since he was a trusted person, banks obliged to his request. After acquiring the money, Harshad Mehta visited the other bank and asked for the bonds for which he will pay the money on the next day. To make the offer of one day extension tempting for the bank, he offered a 15% return to them. Eyeing the good return, bank agreed to this deal. With the help of banks, he was able to maintain a working capital in his account at all times. During those times, the banks were not permitted to make investments in equity markets. With his skills, Mehta was able to arrange some funds from the banking system which he utilized in the stock market and brought a boom in the market. He was responsible for the price hike of ACC from 200 to whooping 9000, i.e. an increase of 4400%.