AN IMPROVED PEDAGOGY OF CORPORATE FINANCE: A CONSTRAINED SHAREHOLDER WEALTH MAXIMIZATION GOAL

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ABSTRACT

The most prominent textbooks in finance literature present the goal of a firm or financial manager as "unconstrained shareholder wealth maximization (USWM)" and focus on economic efficiency and maximization of shareholder wealth, providing limited information about potential constraints. In contrast, constrained shareholder wealth maximization (CSWM) requires students to put equal emphasis on both the objective function (maximizing shareholder wealth) and the constraint (keeping natural stakeholders protected). Our survey of finance textbooks reveals an inadequate level of introduction to these topics, possibly misleading students to believe that society should define its laws in favor of firms (shareholders) at the expense of natural stakeholders. Thus, misinformed students might see stakeholder wealth expropriation as fair game in its extreme form due to our outdated finance pedagogy. In attaining the teaching goal of CSWM as an improved pedagogy, we offer specific suggestions to finance textbook authors.

INTRODUCTION

Bloom's taxonomy (1956) has guided pedagogical structure and innovation for half a century in the United States, and its focus on developmental learning remains relevant and instructive for us. The six developmental levels (knowledge, understanding, application, analysis, synthesis, and evaluation) separate basic knowledge acquisition from the critical thinking and analytical skills necessary for making ethical decisions or judgments. Answering questions about business ethics requires knowledge from multiple disciplines, including philosophy, psychology, political science, sociology, economics, finance, organizational management, and law. Analyzing such a vast body of data in ethical frameworks requires the highest levels (analysis, synthesis, and evaluation) of critical thinking as expressed in the taxonomy. Corporate governance, an interdisciplinary subject addressed in all these disciplines, explores the inter-workings of both for-profit firms and not-for-profit firms and is an area requiring business students to evaluate ethical issues when making decisions.

Despite the broad responsibility of teaching corporate governance in the finance classroom, the pedagogy of finance has been restricted to ideas derived primarily from economics, statistics, and finance. Competing ideas from other disciplines are generally unwelcome and/or are treated with skepticism. Even the ideas of some researchers from the fields of economics and finance such as Hart (1995) and Tirole (2001) who promote alternate solutions to corporate governance beyond agency theory are ignored or overlooked. As a result, business ethics and corporate governance topics often are introduced in a *pro forma,* compulsory fashion that may satisfy the requirements of a business school curriculum, but appear without commitment to their supporting philosophies. Even in schools whose mission should be consonant with alternative economic perspectives (such as the tenets of Catholic social teaching in Catholic institutions), students typically are given little or no exposure to unconventional governance perspectives.

Current finance textbooks do not provide enough information about the constraints of shareholder wealth maximization (SWM), competing corporate governance theories, and business ethics. Finance students are expected to address ethical issues in their careers without having been introduced to the lowest level (analysis) of critical thinking in their schooling years.

Our survey of fourteen frequently-used textbooks in the corporate finance field reveals that almost every textbook uniformly teaches or emphasizes the goal of the firm as unconstrained shareholder wealth maximization, but offers inadequate discussion of competing corporate governance theories and business ethics. The authors of these commonly-used finance textbooks argue that the goal of profit maximization is flawed due to its susceptibility to misuse and manipulation. For example, a manager whose interest is in maximizing self-utility could readily reduce R&D expenses in the short-run, increase current profits, and possibly obtain higher bonuses as a result.

Unconstrained shareholder wealth maximization and agency theory are provided as the sole focus of the firm, in agreement with the most extreme views of Friedman (1971), Jensen (2000), Marcoux (2000), and Sternberg (2000). Ironically, the authors of these same finance textbooks fail to explain the limitations of USWM and agency theory and competing corporate governance theories, and thus under-present finance ethics. This utilitarian perspective, widely accepted in the United States and increasingly accepted internationally, is vulnerable to misuse and manipulation.

Furthermore, we are taught that any divergence from USWM would be discouraged naturally by market forces, namely, stock price adjustments, takeover threats, and firm reputation. However, the very existence of consumer, investor, and environmental laws is a manifestation of the failure of these market forces. Therefore, a more comprehensive introduction to corporate governance theories and discussion of current consumer, investor, and environmental protection laws in the light of business ethics is needed.

The most popular corporate governance theory introduced in finance textbooks is called agency theory. Agency theory, which raises questions about the actions of the principals' agents in conducting business operations (Jensen *et al.* (1976)), provides suggestions as to why there might

be different and conflicting goals among different groups in a firm. Agency theory suggests incentive schemes such as stock options, bonuses, and/or employee stock ownership programs to reduce friction arising from conflict of interest among the groups.

Agency theory is introduced in all finance textbooks as if it provided all the answers needed for business ethics questions. The limitations of agency theory (Bohren (1998) and Tirole (2001)) and other competing corporate agency theories are either only implied or not introduced at all. Nor are finance students introduced to competing ideas in corporate governance, such as stakeholder theory, the commitment to act in consonance with the best interests of all stakeholders, including shareholders (Donaldson *et al.* (1995), Donaldson *et al.* (1999), Freeman (1984), Phillips *et al.* (2003)). The argument presented is that stakeholder theory is not relevant and therefore it is better to ignore it completely.

The result is that we expect students to answer questions requiring value judgments without having provided them with the tools to do so. Students are never introduced to enough corporate governance topics to satisfy the lowest level (knowledge) of Bloom's taxonomy and therefore have a limited information set to tackle ethical problems.

Despite the existence of consumer, investor, and environmental protection laws, recent corporate scandals (Enron, WorldCom, etc.) have led us to question the validity of teachings of USWM, the effectiveness of monitoring market forces, and the appropriateness of incentive schemes provided by agency theory. Some of these scandals show that the natural stakeholders of the firm – environment, employees, and/or local community – are not protected by market forces or incentive schemes, or by the existing consumer, investor, and environmental protection laws.

The remainder of the paper is constructed as follows. In Section 2, we present and elaborate on the nature of the teaching goal of constrained shareholder wealth maximization. Section 3 provides a survey of 14 finance textbooks in reference to four dimensions. In section 4 we suggest an improved pedagogy to finance textbook authors that would achieve a balance between the goal of shareholder wealth maximization and the protection of natural stakeholders. We conclude in section 5 with a summary of our arguments.

TEACHING SHAREHOLDER WEALTH MAXIMIZATION WITH A CONSTRAINT

In this paper, we propose teaching shareholder wealth maximization goal as *subject to a constraint* wherein the wealth of all stakeholders is preserved and protected. Teaching of this goal is more comprehensive and requires discussion of corporate governance theories, the adequacy of current consumer, investor, and environmental protection laws, and evaluation of business ethics. Therefore, the teaching focus is not only on the objective function (shareholder wealth maximization) and economic efficiency but also on the constraint (protection of natural stakeholders) and therefore value judgments. Thus, it is not limited to the views of Jensen (2000). Jensen assumes that market forces (stock price adjustment, takeover threats, reputation, etc.) will

provide enough protection to natural stakeholders. In Jensen's world, the externalities (side effects) arising from the managerial decisions harming natural stakeholders are left unchecked. The proponents of shareholder maximization theory claim that the protection of stakeholder wealth is achieved by market forces, and it is usually reflected in share prices. However, there were massive market force failures in addition to the protection of current laws that let us experience the recent corporate scandals.

In the case of Enron, for example, massive profits taken on projected but unfulfilled sales and the development of a flexible accounting process cost employees their retirements and destroyed a respected accounting firm. In the case of WorldCom, unintegrated acquisitions, sweetheart loans, and inappropriate relationships between analysts and the company they were reporting on led to unprecedented public and private losses. Clearly, teachings of a more effective corporate goal and a comprehensive discussion of corporate governance is required in our universities and finance textbooks.

In this paper, we do not discuss how to achieve shareholder wealth maximization goal while keeping other stakeholders protected. Nor do we suggest changing the firm goal or teaching only stakeholder theory as advocated by Freeman (1984). Rather, we suggest expanding the business curriculum to include a more complete view of business and finance ethics. Teaching CSWM is not the same as the promotion of stakeholder theory in which maximizing the wealth of both shareholders and natural stakeholders is proposed. CSWM suggests that shareholder wealth maximization should not be achieved at the expense of stakeholders such as employees, environment, local community, creditors, and similar entities. CSWM does not advocate wealth maximization for all stakeholders; instead, it proposes a better explanation and teaching of the constraints on management. The suggestion that market forces (stock market adjustment, takeover threats, market reputation, etc.) will protect stakeholders from unscrupulous actions is unwarranted by the very existence of consumer, investor, and environmental protection laws.

Corporate finance textbooks need not take a specific stance on corporate governance issues. Instead, they should take a more neutral role in promoting ideas and provide both sides of the story. Otherwise, we are likely to mislead society into defining its laws in favor of firms (shareholders) at the expense of natural stakeholders.

CORPORATE FINANCE TEXTBOOK SURVEY

Surveying textbooks in research studies is not a new concept. For example, Norgaard (1981) outlined 18 finance textbooks that examined the evolution of the finance field. Hawley (1991) surveyed 22 corporate finance textbooks and analyzed the coverage of ethics and social responsibility topics for corporations. Borokhovich *et al.* (1995) examined 16 corporate finance textbooks for journal citations. Ardalan (2002) reviewed 32 introductory finance textbooks supplied by the major publishers to analyze the subject of the after-tax cost of debt. Jalbert (2002) surveyed

7 popular finance textbooks to analyze the presentation of the time-value-of-money topic. Eriksson (2004) surveyed a number of textbooks in environmental economics in respect to their treatment of ethical issues.

Our paper follows Hawley's (1991) work and reexamines the current textbooks in terms of coverage of ethics and social responsibility. In addition, our paper surveys the presence of information about constrained shareholder wealth maximization and proposes a more comprehensive pedagogy of finance teaching to include the often omitted or overlooked topics of ethics and social responsibility. This survey covers corporate textbooks taught at introductory, intermediate, and advanced levels as well as the ones in the area of international finance in the undergraduate and MBA courses.

Table 1 below provides detailed data from the survey described above. For the 14 textbooks we evaluated, these data include: i) number of pages and percentage of the total book pages devoted to a discussion of agency theory, corporate governance, ethics, and stakeholder theory, ii) number of pages and percentage of the total book pages devoted to the stated goal of the firm or financial manager, iii) number of instances that agency theory, corporate governance, ethics, and stakeholder or corporate wealth maximization appear in the index, and iv) inclusion in the glossary of these four items, that is, agency theory, corporate governance, ethics, and stakeholder or corporate wealth maximization. In addition, all publication information for the textbooks is listed. Some of the findings are surprising, some disturbing, and some confusing. All indicate a diminution over the past 15 years (since Hawley's (1991) study) of interest on the part of finance educators about issues of business ethics, stakeholder theories, and consideration of alternate firm goals.

Table 1: A Survey of Frequently-used Finance Textbooks*

Textbook and Author(s)	No. of Pages and percent of the total (1)	Stated Firm or Financial Manager Goal (2)	No. of Listings in Index (3)	Inclusion in Glossary (4)	Undergraduate (UG) or Graduate (MBA) Textbook (5)
Brealey, Myers & Markus (2001) *Fundamentals of Corporate Finance, 3/e,* McGraw-Hill-Irwin, 798 pages.	9 1	USWM	(a) 4 (b) 2 (c) 3 (d) 0	(a) YES (b) NO (c) NO (d) NO	UG, MBA
Brigham & Daves (2004) *Intermediate Financial Management, 8/e*, Thomson-South-Western, 1038 pages.	36 3	USWM	(a) 14 (b) 12 (c) 10 (d) 0	(a) YES (b) NO (c) NO (d) NO	UG, MBA
Brigham & Ehrhardt (2005) *Financial Management: Theory and*	40 4	USWM	(a) 5 (b) 12	(a) YES (b) NO	UG, MBA

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Practice, 11/e, Thomson-South-Western, 1,000 pages.			(c) 23 (d) 0	(c) NO (d) NO	
Emery, Gary W. (1998) *Corporate Finance: Principles and Practice,* Addison-Wesley, 893 pages.	16 2	USWM	(a) 16 (b) 0 (c) 0 (d) 0	(a) YES (b) NO (c) NO (d) NO	MBA
Gitman, Lawrence J, (2003) *Principles of Managerial Finance, 10/e*, Addison-Wesley-Pearson, 882 pages.	11 1	USWM	(a) 6 (b) 0 (c) 5 (d) 0	(a) YES (b) NO (c) YES (d) NO	UG
Grinblatt & Titman, (2002) *Financial Markets and Corporate Strategy, 2/e*, McGraw-Hill-Irwin, 880 pages.[5]	16 2	USWM	(a) 3 (b) 0 (c) 0 (d) 13	(a) __ (b) __ (c) __ (d) __	MBA
Keown, Martin, Petty & Scott, (2002) *Financial Management: Principles and Applications, 9/e,* Prentice Hall, 801 pages.	16 2	USWM	(a) 6 (b) 0 (c) 10 (d) 0	(a) YES (b) NO (c) NO (d) NO	UG
Lasher, William R. (2003) *Practical Financial Management, 3/e*, Thomson-South-Western, 696 pages.	12 2	USWM	(a) 2 (b) 0 (c) 10 (d) 0	(a) YES (b) NO (c) NO (d) NO	UG
Madura, Jeff,(2003) *International Financial Management, 7/e*, Thomson-South-Western, 696 pages.	5 1	USWM	(a) 4 (b) 0 (c) 1 (d) 0	(a) YES (b) NO (c) NO (d) NO	UG, MBA
Moffett, Stonehill & Eiteman (2006) *Fundamental of Multinational Finance, 2/e*, Pearson-Addison-Wesley, 623 pages	24 4	USWM and CWM	(a) 2 (b) 20 (c) 1 (d) 1	(a) NO (b) YES (c) NO (d) YES	UG, MBA
Ross, Westerfield & Jaffe (2005) *Corporate Finance, 7/e*, McGraw-	14 1	USWM	(a) 13 (b) 0	(a) YES (b) NO	UG, MBA

Table 1: A Survey of Frequently-used Finance Textbooks*					
Textbook and Author(s)	No. of Pages and percent of the total (1)	Stated Firm or Financial Manager Goal (2)	No. of Listings in Index (3)	Inclusion in Glossary (4)	Undergraduate (UG) or Graduate (MBA) Textbook (5)
Hill-Irwin, 942 pages.			(c) 0 (d) 1	(c) NO (d) NO	
Ross, Westerfield & Jordan (2006) *Corporate Finance, 7/e*, McGraw-Hill-Irwin, 892 pages.	7 1	USWM	(a) 5 (b) 0 (c) 2 (d) 0	(a) __[5] (b) __ (c) __ (d) __	UG, MBA
Shapiro & Balbirer (2000) *Fundamentals of Corporate Finance: A Multidisciplinary Approach to Value Creation,* Prentice Hall, 577 pages.	27 5	USWM	(a) 23 (b) 4 (c) 0 (d) 0	(a) YES (b) NO (c) NO (d) NO	UG
Shapiro, Alan C. (2002) *Foundations of Multinational Financial Management, 4/e*, Wiley, 634 pages.	3 0	USWM	(a) 0 (b) 3 (c) 0 (d) 0	(a) YES (b) YES (c) NO (d) NO	UG, MBA

* The surveyed textbooks are at the levels of introductory, intermediate, international, and advanced corporate finance and/or financial management.
(1) Total number of pages in which the issues of agency theory, corporate governance, ethics, and stakeholder theories are explained, discussed or mentioned in the textbook are presented on the first line and their percentage of the total number of book pages are presented on the second line.
(2) USWM: Unconstrained shareholder wealth maximization, CSWM: Constrained shareholder wealth maximization, CWM: Corporate wealth maximization (corresponds to stakeholder wealth maximization theory).
(3) (a) Agency theory, (b) Corporate governance, (c) Ethics, (d) Stakeholder theory and/or corporate wealth maximization.
(4) Same as in 3.
(5) No glossary is available.

Finance textbooks are thick, extending from 577 pages to 1038 pages, with an average of over 810 pages. The number of pages devoted to our four areas of interest range from a high of 40 pages (out of 1038 pages) in Brigham *et al.* (2005) to a low of 3 pages (out of 634 pages) in Shapiro (2002). The proportion of the books devoted to these topics ranges from 0 percent (Shapiro (2002)) to a high of 5 percent (Shapiro *et al.* (2000)). The vast majority (9 textbooks) have 1 to 2 percent committed to the four topics.

Overall, most textbooks state that the firm's or financial manager's goal is unconstrained shareholder wealth maximization. Moffett *et al.* (2006) is the only textbook that introduced concepts similar to a constrained shareholder wealth maximization as an alternate to the traditional goal. According to Moffett *et al.*, the acceptance of unconstrained shareholder wealth maximization is a

cultural norm adopted mostly by the Anglo-Saxon countries which have a social and economic focus on the individual rather than the collective (Lutz (2003)). In contrast, many firms in Europe and Asia establish the firm's goal as "corporate wealth maximization." Corporate wealth maximization means a firm should not only maximize the shareholders' wealth but also the wealth of other stakeholders in a corporation. However, Moffett *et al*. do not go so far as to suggest that constrained shareholder wealth maximization should be a goal for the firm in the United States.

Corporate governance is also given short shrift in the textbook universe. Out of the 14 textbooks surveyed, only 2 mention corporate governance in the glossary and 8 do not even have a listing in the index for this topic. Moffet *et al.* provide a fine introduction to corporate governance issues with more than 20 mentions of the topic in its index compared to a total of 31 mentions in all the other textbooks combined. Gitman (2006) also provides some information about corporate governance and firm goals but also falls short of providing the competing theories from the literature.

One of the reasons for the lack of discussion of corporate governance in these textbooks could be the lack of a generally accepted definition of the meaning of corporate governance. Is it to be defined narrowly, as the relationship between the shareholders, directors, and management, governed by the by-laws of the corporation? Or is it to be defined more broadly as the balance between economic and social goals? If we use the former definition, we must acknowledge that the corporation has created its own universe, with its own rules, laws, and character (the problem inherent in agency theory). If the latter, we can no longer accept the position that economics is amoral, that is, we must acknowledge that some goods are "good" and other goods are "bad" and ought not to be sold. Either way, we have established an untenable position philosophically. Doing business ethically means making *ethical* choices, and these choices can be difficult, confusing, and impossible to make in the role of an agent.

Agency theory is generally accepted as an important component of the study of finance. Eleven of the 14 texts include agency theory in the glossary and all but one textbook has multiple listings of agency theory in the index. Shapiro *et al*. (2000) has a high of 23 different index listings for agency theory and this is the same textbook that devotes 5 percent of its pages to the four topics under consideration.

It seems clear that significant changes need to occur, primarily in the addition of a broader discussion of business ethics and related topics in the finance textbooks.

A SUGGESTED PEDAGOGY FOR CORPORATE FINANCE TEXTBOOKS

We suggest that finance textbook authors and publishers include additional topics in corporate finance. The goal of shareholder wealth maximization should be balanced with an equal emphasis on the protection of natural stakeholders. In addition to the efficiency concerns vis-à-vis shareholder wealth maximization, the natural stakeholders interests should be discussed since the

success of a firm depend on all participants. Students must be provided both theory and examples of practice that will allow them to make reasonably informed decisions and attain the highest levels of critical thinking in Bloom's taxonomy.

In the outline of a typical corporate finance textbook, there are usually five parts: I. Introduction to financial management and environment, II. Capital Budgeting, III. Capital Structure, IV. Short Term Financial Management, and V. Special Topics. Each part consists of a number of chapters, and commonly 15 to 25 chapters are introduced in a typical textbook.

We suggest that the following additional topics and discussions be included in corporate finance textbooks to improve the finance curriculum. These suggestions are not meant to be all-inclusive but rather provide the basic elements of attaining the teaching goal of CSWM as an improved pedagogy. Such discussion should provide a more holistic treatment of alternate firm theories and business ethics with the aim of elevating students to the highest levels of critical thinking. Such a paradigm also would help operationalize AACSB's requirement that ethics must inform every course in the business school curriculum.

Part I: Introduction to Financial Management and Environment

Chapter 1: Introduction to Financial Management

Discussion of a goal for the firm and financial managers provides introductory but fundamental issues for finance students. In addition to teaching a firm's goal, the possible constraints on the firm's goal should be clearly emphasized. The following elements are recommended for inclusion to provide finance students with a more comprehensive exposure to social responsibility and ethical business decision making.

(a) Teaching constrained shareholder maximization (CSWM)

A constrained shareholder maximization view proposes that the firm's goal should include shareholder wealth maximization subject to the preservation of other stakeholders' wealth. Here, the concern is to *preserve* stakeholder wealth while achieving the goal of shareholder wealth maximization. This clearly recognizes that shareholder wealth maximization can be achieved at the expense of other stakeholders via a number of strategies (including manipulation). How to achieve the protective constraints is not a straightforward issue and discussions about a solution will demand students to reach the highest levels of critical thinking. An equal attention to the constraint (protection of natural stakeholders) in addition to the objective (shareholder wealth maximization) will be required. For example, Tirole (2001) questions the sole focus on the objective:

> *To many people the economists' and legal scholars' sole focus on shareholder value appears incongruous. Managerial decisions do impact investors, but they also exert externalities on a number*

of "natural stakeholders" who have an innate relationship with the firm: employees, customers, suppliers, communities where the firm's plants are located, potential polluters, and so forth. There is no denying that such externalities may be substantial; for example, the closure of a plant by a major employer in a depressed area has dramatic consequences for its workers and for the local economy. Why should institution design ignore natural stakeholders, and favor the investors, who are "stakeholders by design," by giving them full control rights and by aligning managerial compensation with their interests?

Furthermore, Lutz (2003) criticizes business school teachings:

In most Western business schools today, the principle that managers must strive to maximize long-term owner value is regarded as an axiom requiring no argument. It is, however, a normative theory of human action that has emerged from a particular philosophical and cultural tradition, and should be subjected to critique and assessment just like any other normative theory of human action. When it is assessed, it is found to be indefensible.

(b) Introduction to corporate governance

Corporate governance is a prime opportunity for students to understand and discuss a wealth of intra-disciplinary topics as it intersects with other disciplines such as economics, philosophy, organizational management, political science, sociology and psychology. There is a large spectrum of ideas on corporate governance determined by cultural and historical backgrounds of nations. Defining the rights of a corporation and its limits in interaction with society is determined by electoral choice. However, most corporate laws are determined in the light of cultural norms. In the final analysis, corporate governance discussions boil down to how to share corporate wealth among participants. There are two polarized views on corporate governance: one advocating and defining laws to support shareholders as the sole claimant of the wealth created, and the other maintaining that corporate wealth should be shared among all stakeholders.

(c) Limitations of agency theory

Finance textbooks have ample coverage of agency theory. However, the limitations of this theory currently are not discussed. Bohren (1998) questions agency theory's assumptions and suggests that the assumed agent's behavioral norms deviate from commonly held ethical values in society. Additionally, Bohren proposes an analysis of descriptive validity of a non-standard agent who is pessimistic and an extreme model of man who is indifferent between honesty and dishonesty. In examining the Enron debacle, Culpan and Trussel (2005) suggest that even though agency theory explains the fiduciary behavior of agents vis-à-vis shareholders, it does not address the protection of the interests of other stakeholders of the company, including employees and creditors.

(d) Introduction to stakeholder theory

Even though the stakeholder theory is the only competing theory in corporate governance, current finance textbooks do not cover stakeholder theory. Stakeholder theory proposes that a firm's goal should be to maximize not only shareholders' wealth but also the wealth of other stakeholders. According to this view, a firm is comprised of shareholders and other stakeholders and a firm's success depends on their harmonious combined operation. Therefore, the rewards of a successful firm should be shared among all the stakeholders. There are, however, several variants of this theory to consider when attempting to operationalize this approach in order to achieve a workable system among the stakeholders.

For example, Phillips (2003, 2004) explores the moral obligation owed to stakeholders and suggests that stakeholder communication is more than good for the organization – it is a moral obligation. He posits that individual and groups who contribute to the organization should be permitted some say in how that organization is managed.

Chapter 2: Financial Statements and Taxes

Financial reporting and the accuracy of financial statements can be seen as a fundamental requirement for financial markets to work efficiently. An anonymous article (1997) in the Journal of Accountancy identifies a strong relationship between a corporation's culture and its financial statements. If there are problems such as sexual harassment or diversity clashes in a company, it should be expected that some of these problems will find their way to the financial statements.

In response to the recent corporate scandals, the Sarbanes-Oxley Act brought new regulations to ensure confidence in financial markets. According to George (2003), the Sarbanes-Oxley Act increased audit committees' responsibilities, requiring them to help prepare the audit, ratify the internal control system, and resolve disputes over accounting rules. George does not see audit committees as helpful and concerned about the independence of external and internal auditors from corporate management. Further, George suggests that an independent institution should hire and/or fire both internal and external auditors of a firm and thus keep ethical standards consistent. Staubus (2005) sees the close relationships between auditors and corporate management as a potential problem for the future. Staubus states that biased or fraudulent financial reporting is inescapable since top management in corporations is strongly motivated to produce favorable reports. Independent auditors are also heavily influenced by the management due to their clientele relationships.

Outsourcing has been a controversial topic and is increasingly a trend in the corporate world. Tax returns and the outsourcing of their preparation overseas has been questioned on ethical grounds (McGee (2005), Mintz (2004), Stone (2004)). According to them, a client is not informed that his/her tax information is being transmitted overseas electronically and that the return will be

prepared by a non-U.S. CPA. Therefore, the current problem-free application of outsourcing tax returns does not mean that the ethical standards have not been compromised. A further concern is that a U.S. CPA cannot oversee directly the operations that are outsourced overseas, nor can the U.S CPA ensure that proper security measures are in place to protect the clients' interests. Additionally, it is difficult to verify the qualifications of the overseas accountants.

Chapter 3: Time Value of Money

This chapter is essential for finance students to be able to value real assets, loans, and financial instruments. It is technical and filled with examples and applications of present and future value calculations for different types of loans. Despite the topic's technical nature, this chapter is not free from ethical issues and concerns.

The imperfect valuation of loans and assets can affect the well-being of the largest financial institutions such as banks and other depository institutions. An unfortunate failure of a bank or depository financial institution sends shock waves through the economy, affecting many people across many sectors. Trugman (1991) reminds us that, after the financial collapse of savings and loans institutions (S&Ls), a new act in 1989 called the Financial Institutions Reforms, Recovery, and Enforcement Act was passed. The main reason, Trugman explains, for the failures of the S&Ls was related to questionable loans that were collateralized with overvalued real estate assets. Additionally, Nadler (1991) warned banking institutions of their refusal to write down questionable loans because the impact of the write-down on stated earnings might result in extensive damage later as banks would be left open to class action suits.

Banks play a special role to bring the demand and supply sides of loanable funds and therefore they should be at the center of ethical business practices. Green (1989) sees deregulation and technological revolution as sharpening our ethical conflicts in the banking sector. According to Green, a bank's lending responsibilities affects whole communities and requires special attention since competition and survival might tempt us to compromise our ethical stance. Furthermore William *et al.* (1992) investigates ethical behavior among bank employees. They find that younger employees had a higher level of ethical consciousness than older employees. According to their research, the longer one works for a company, the more one may look to job security as a priority, and this might lead to rationalizing or overlooking apparently unethical behaviors. Additionally, Kitson (1996) investigates the effectiveness of corporate codes of ethics on the day-to-day behavior of British cooperative bank managers and find that banks were successful in integrating a code of ethics into daily processes, and that bank managers believe that the code of ethics policy helped them to attract new business.

Chapter 4: Interest Rates, Bonds, Stocks, Financial Derivatives, and Markets

Insider trading is a controversial issue and has ethical implications. Research about insider trading laws is extensive in the finance literature, and these discussions can expose finance students to both theoretical and ethical issues about market efficiency. For example, Shefrin & Statman (1993) present the trade-off between efficiency and fairness in insider discussion. They argue that prohibiting insider trading violates the right to engage freely in trade, but permitting legalized insider trading violates the right to equal information. As a result, they propose insider trading as an ethical and political consensus issue. Treynor & LeBaron (2004) also provide two opposing views. Treynor claims that insider laws provide protection and confidence to average investors from insiders with superior information. In turn, this provides access by average investors to financial markets, providing higher volume and thus liquidity. In contrast, LeBaron argues that insider trading helps price discovery and thus market efficiency. Therefore, LeBaron suggests continuous participation of insiders in daily trading to improve market efficiency. Caccese (1997) sees insider trading prohibitions as an important factor in maintaining market integrity and investor confidence. Caccese emphasizes the role of the investment analyst in the process of information dissemination and suggests a test for market participants to determine whether or not the information they receive or give is subject to insider trading prohibitions. Furthermore, Ma & Sun (1998) argue that the ethics of insider trading is an economic rather than a moral issue. They urge that it is a mistake to over-regulate insider trading since it is not clear if insider trading increases or decreases shareholders wealth.

Abdolmohammadi and Sultan (2002) observe a sample of accounting and finance students performing competitive trading in their trading room with and without insider information, and they find that there was a positive relationship between ethical reasoning and ethical behavior. They conclude that brokerage firms should train stockbrokers extensively in ethical issues since people with higher levels of ethical reasoning are less likely to use insider information in stock trading.

The techniques regarding financial derivatives are relatively difficult for beginners in finance. Financial derivatives are useful, but could be financially damaging if they are not applied properly. According to Raines & Leathers (1994), derivatives have been viewed historically as gambling instruments. However, they show that over time, our perspective on ethics has changed, making financial derivatives legitimate tools. The pricing of financial derivatives also has been an intricate and complex topic. Currently, financial institutions use the Black-Scholes and binomial pricing techniques to achieve better pricing for financial derivatives. However, Clark *et al.* (2003) suggest that implementation of the Prudent Investment Rule is important in financial advising, especially as it relates to over-the-counter derivative pricing. They suggest that an independent performance appraisal might be needed to guide investment advisors and security dealers in adhering to ethical standards due to the existence of conflicts of interest about over-the-counter derivative pricing.

Chapter 5: Risk and Return, and Portfolio Risk Management

Financial engineering is a developing area in hedging against risks such as changes in interest rates and foreign exchange rates for which firms cannot buy insurance to cover themselves. Nonetheless, the scope of financial management should be expanded according to Carris & Duska (2003). Managerial actions and consequences are not fully predictable, and therefore firms may not cover all their losses with insurance. Identifying unethical behavior of managers of firms and the consequences of these behaviors might help protect against liability torts and property losses as potential risks. They urge risk managers to take into account the threat of internal ethical hazards for an organization's long-term prosperity. In addition, Drennan (2004) claims that risk management is not a new phenomenon and ethical breakdowns in corporate finance are a peril and should be seen as part of risk management since they might even cause bankruptcy or significant reputation and monetary losses. In order to manage ethical failures effectively and encourage ethical conduct of business, a system of identification and detection system is needed.

Risk and return has always been at the center of financial investments and portfolio analysis. Arnott (2004) warns that if corporations fail to enforce ethical standards, the risk will increase, and investors will expect increasing returns. The higher yields might lower asset prices, and this effect, combined with excessive regulation could cause a bear market.

In portfolio management, the share of mutual funds is growing and allowing even the smallest investor to benefit from diversification. Houge and Wellman (2005) analyze the stock market price reaction (investor reaction) to mutual fund companies when they were involved in the trading abuses (specifically late trading) of financial securities. They suggest that the SEC should help eliminate market timing schemes by using a two-pronged approach that combines fair value pricing and mandatory short-term redemption fees.

Part II: Capital Budgeting

Chapter 6: Capital Investment Decisions

Value estimations and acceptance or rejection decisions for the potential projects are important part of finance teaching. The decision techniques compare the benefits of projects with their costs to come up with a final decision. However, the very nature of acceptance or rejection of a project exposes project participants to conflicts of interest and ethical issues. For example, Madison (2005) provides an example in which a financial analyst is pressured by the CFO of a corporation to increase the salvage value of a corporate executive jet and reduce the lifetime of a project to make net present value (NPV) positive. Thus, NPV project estimations are sensitive to the underlying assumptions, and require ethical standards to be applied to obtain meaningful decisions.

Devaney (1991) warns against stubbornness and managerial ignorance when the financial measures show that the proposed project is not feasible. According to Devaney, bankruptcy courts are filled with companies that persisted in the development of projects long after their NPV values had become negative. Despite the early negative signs of capital budgeting projects, Devaney believes that project champions go unchallenged by accounting and finance specialists because of the corporate power structure.

The societal and ethical considerations cannot be measured in a classical capital budgeting framework. For example, Lumley (1997) suggests that using a single discount rate in the NPV process to discount cash flows of environmental projects may not be appropriate. According to Lumley, if a single discount rate is applied to environmental resources, the implication of non-monetary aspects of those resources is often ignored. Therefore, the standard practice of discounting techniques in NPV does not guide government to provide for the community good, since those projects are found to be negative net present value.

Part III: Capital Structure

Chapter 7: Cost of Capital, Capital Structure, and Financial Leverage

Capital structure theories in finance address the frictions among the shareholders and natural stakeholders when debt levels and the bankruptcy probability of a firm is high. Only agency theory is introduced to resolve the conflicts of interest among the groups. However, other ethical considerations before or during the bankruptcy process should be presented in this chapter. For example, Salem & Martin (1994) question a firm's use of bankruptcy as a strategic option to escape from contractual obligations to its customers, suppliers, and other stakeholders. They discuss the balance and design of rehabilitative or punitive bankruptcy laws and their resulting consequences from an ethical perspective. In addition, Payne & Hogg (1994) view the solution of Chapter 11 bankruptcy from legal, managerial, and moral perspectives. They also question managers' manipulation of Chapter 11 laws in their own favor with substantial costs to creditors, employees, and stockholders.

During economic downturns, firms with high financial leverage are more prone to bankruptcy. The resulting bankruptcies sharpen differences between stakeholders and bring ethical considerations to the press and media attention. Kilpi (1996) suggests that wealth appropriated through financial leverage is not unethical. Kilpi warns that the punishment during the economic downturns related to business bankruptcies with high levels of debt should not be considered any differently because of the association of debt and luxuries.

Equity financing as well as debt financing can be used to make adjustments to capital structure. Debt versus equity financing is not only an issue of optimal capital structure for firms but also a discussion in development economics. Traditionally, debt has been used to finance

development projects. According to Wilson (1993), equity financing can be seen not only from a capital structure perspective but also from the viewpoint of promoting development. In the light of extensive borrowing and problems in the Third World countries, Wilson believes that equity financing could be an alternative way to promote economic development. Unlike debt, equity financing is well-justified for high-risk development projects since the risk is distributed over those who would like to participate in these projects.

The ethical issues surrounding the bankruptcy crosses even the borders of religion. For example, Sutherland (1988) introduces a biblical perspective to bankruptcy while Tamari (1990) explains a Jewish perspective of bankruptcy.

Chapter 8: Dividends, Stock Repurchases, and Raising Capital

Shareholders of corporations have limited liability. One of the explanations why firms can raise capital easily is due to limited liability. Sollars (2001) defends a "proportional liability" concept instead of limited liability. Sollars claims that since shareholders receive dividends and capital gains that are not predetermined, shareholders should be liable for the same proportion of a corporation's excess of liabilities over assets that the number of shares bears to the total number of shares outstanding.

Agency problems and ethical considerations in corporate governance are numerous, even in the case of dividend payments. Belden *et al.* (2005) report that there is a relationship between the composition of a board of directors and the level of dividend payments. Boards have greater monitoring power when there is more outside board director representation, and the dividend payments are expected to be higher. Here the underlying assumption is that managers might waste earnings without the monitoring of an outside board of directors. Brunarski *et al.* (2005) also report that their findings support the idea that higher dividend payments might reduce agency costs. They find that, on average, firms with a majority of strict outside directors on their boards experience significantly lower mean abnormal returns around the announcements of sizeable dividend increases. Government regulations are often used to enhance efficiency in financial markets. For example, shareholder passivity is a concern, and often governments introduce new rules to curb the power of corporate managers or other market players. International Financial Law Review (2005) recently reported that Germany wants to let companies pay higher dividends to shareholders who exercise their votes at the shareholder meetings. This move is intended to increase investors' participation and reduce hedge funds' influence as large shareholders on German corporations.

Additionally, in the finance literature, a stock repurchase program announcement is perceived as a positive signal to the market participants of a firm's financial prospective. Therefore, at the repurchase dates there are increases in the stock prices. However, Fried (2005) introduces false signaling of firms through open market repurchases to increase firm value. Fried claims that managers buy firm shares at bargain prices, boost prices with the announcements of repurchase

programs, and sell their shares later at higher prices. Thus, managers transfer a significant value from public investors to their own wealth.

Part IV: Short-term Financial Management

Chapter 9: Working Capital Management

Short-term asset management and its financing decisions also require managers and employees of a firm to be ethical. Thornhill (1988) explains how managers might act unethically due to mounting pressures of daily operations. According to Thornhill, factors such as insufficient working capital, inability or reduced ability to acquire credit, and poor turnover of receivables could potentially create an environment where fraud among managers and staff members becomes common practice. Rosner (2003) investigates failing firms and possible earnings manipulation for a group of bankrupt firms and a control group of other firms. Rosner finds that there were income increasing earnings manipulations in the pre-bankruptcy statements of failing firms. Non-stressed bankrupt firms prior to their bankruptcy had greater amounts of investment in receivables, inventory, property, plant and equipment, sales, net working capital, and current and discretionary accruals than control firms in the sample. Additionally, Payne (2002) and Brannen (2002) list ten working capital mistakes. One of them is "delaying payments to suppliers as a tactic to increase cash flow without first trying to negotiate better terms and gain discounts for prompt payments." The concerns of both Payne and Brannen obviously have ethical dimensions in the framework of working capital management as well.

Profiting float as cash management could potentially conflict with corporate ethics. Davis (1987) provides the example of The E. F. Hutton incident. Hutton was charged with fraud in 1985 in a version of cash management where checks in small banks were used to slow down payment distributions. In a similar way, a typical corporate finance book (Ross *et al*. (2005)) introduces "accelerating collections" and "paying more slowly" as methods of cash management, which opens the door to ethical criticisms.

Part V: Special Topics

Chapter 10: International Financial Management

Multinational corporations (MNCs) and their operations overseas have been controversial because of the many ethical violations in the past. Therefore, media attention and research into the ethical practices of multinational corporations is extensive in the finance literature. For example, Fox *et al*. (2005) analyze foreign direct investment (FDI) in China and find violations of ethical standards with poor pay, unacceptable work conditions, and employee treatment. They suggest that

the Chinese code of conduct for managers and institutions should resist the perception that all these ethical issues are a part of doing business in China. Further, Marjorie (1990) states that foreign direct investment and multinational capital budgeting decisions require moral and ethical reasoning beyond rational and normative financial thinking.

Historically, the topic of corporate codes of ethics and their effectiveness has been the focus of corporate finance literature. White and Taft (2004) introduce corporate codes of conduct for multinational corporations from Western and non-Western frameworks to allow faculty and students to explore ethical problems with a wide array of national and cultural differences.

International competition and MNCs' dumping strategies also have their ethical dimensions. Michalos (1997) introduces the ethics of "social dumping" in which companies are able to sell their products in foreign markets with prices below the cost of production at home because employees of the company or local residents have been forced to absorb the losses themselves. According to Michalos, the local costs to employees and residents for environmental pollution provide the simplest example of social dumping. Further Michalos is concerned about Third World debt as an ethical issue in international finance.

Transfer pricing is both an accounting and finance topic that envelops ethical considerations. According to Mehafdi (2000), unethical transfer pricing behavior could be damaging to corporations and host governments. Medhafdi sees Arm's length legislation in transfer pricing as insufficient and suggests self-regulating codes of conduct for senior management.

Finally, the negative environmental effects of MNC operations are a major concern in international finance. Andersson *et al.* (2005) question MNCs' commitment to ecological sustainability. They find that the employees at MNCs are sensitive to environmental issues if the issue is promoted by the top management.

Chapter 11: Mergers and Acquisitions

The emphasis in finance about the effects of mergers and acquisitions is economic efficiency, and the benefits of mergers are primarily investigated through synergy and other economic factors. Ethical issues in mergers and acquisitions are usually omitted, and issues about mergers' effects on the natural stakeholders are not explored. According to Di Norcia (1988), merger decision power is not distributed in proportion to the natural stakeholder risk, and the risk falls mostly on employees, somewhat on managers, less on owners, and least on investors. Additionally, Di Norcia questions why employees should pay for investor, owner or management errors. In addition, Walter (1983) sees the scope of takeovers beyond the conflict of interest between management and stockholders. Walter suggests a conscientious research effort to sort out the complex forces at work and strengthen codes of ethics.

CONCLUSIONS

Our survey of corporate finance textbooks reveals that students of finance are deprived of a complete education regarding a balanced approach to the firm goal, corporate governance theories, and adequate business ethics discussion. The introduction of a constrained shareholder wealth maximization perspective will enhance the business ethics curriculum since the teaching of the objective (shareholder wealth maximization) as well as the constraint (protection of natural stakeholders) exposes finance students to corporate governance and higher levels of critical thinking. The current omission of competing theories of ethics in corporate finance textbooks leaves students with an incomplete world view of corporate governance. An ethics education for MBA and undergraduate finance students that focuses only on shareholder wealth maximization goal encourages society to define its laws in favor of corporations so that other stakeholders are left unprotected. AACSB has stated unequivocally that ethical and legal responsibilities in organizations and society must inform every course in the business school curriculum; finance textbooks are failing to do their part.

We recommend that corporate finance textbooks take the responsibility to improve their current offerings by providing both sides of the story through teaching of constrained shareholder wealth maximization and competing theories in corporate governance, and by providing adequate exposure to business ethics. By doing so, students will be able to make informed managerial decisions. In the continued long-term omission of adequate ethics teaching, corporate scandals are likely to become a mainstream phenomenon rather than an anomaly.

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NOTES

1 Mentioning stakeholders of a firm, usually within agency theory, does not mean that stakeholder theory has been introduced.

2 Corporate social responsibility discussed in the context of agency theory does not mean that stakeholder theory has been introduced.

3 Including stakeholder definitions in the glossary does not mean that stakeholder theory has been defined or explained.

4 Corporate governance is not the same as corporate control, which is related to the mechanics of existing organizational structure and rules.