Fundamentals of Financial Ethics

All organizations need money to operate. But where does that money come from? Where should it be invested, and how can it grow? That’s where finance comes in. **Finance** is the process of obtaining funds and using them to achieve the goals of a business. It includes all issues related to money and money management. Careers in finance can vary greatly, but in general, finance professionals make sure that businesses are using money effectively. If you work in finance, your job title might be credit analyst, capital budgeting specialist, financial analyst, project analyst and finance manager, or cash manager, for example. On a day-to-day basis, financial professionals assist with mergers and acquisitions, analyze and manage the allocation of financial capital, create financial models and projections, find ways to increase profitability, and oversee a company’s investments.

Without solid finance practices, companies would struggle to make financially viable decisions and to make a profit. One way to make sure that all financial matters run smoothly is to follow the highest standards of **ethics**. Ethics are the basic principles that govern behavior. They guide people to know what is right and what is wrong. Ethics are incredibly important in finance because of the damaging effects that unethical financial practices can have on companies, their employees and customers, and the economy as a whole.

Financial professionals are confronted with a wide range of ethical dilemmas. They might have to decide between telling the truth or telling their employers what they want to hear. Upper management might pressure them to support certain business decisions, or they might strive to increase profitability in ethically questionable ways. Financial professionals might be tempted to overstate projections or tweak analyses in ways that can cause problems for businesses down the road. However, when financial professionals turn a blind eye to unethical behavior, things can go terribly wrong. People can lose their jobs, companies can go out of business, and billions of dollars can be wasted.

Why Be Unethical?

If the consequences are so severe, why do finance professionals continue to act unethically? Unfortunately, the finance field is full of temptations and pressures to engage in unethical behavior. A small number of people are simply greedy: The ability to make a large amount of money can be too appealing to resist. However, most people are not actively trying to be unethical for their own personal gain. So why do they find themselves in difficult ethical dilemmas? Over time, economists and psychologists have identified several key phenomena that affect financial professionals’ ability to make the right decisions.

**Obedience to authority.** People have a natural tendency to want to please authority figures, such as their parents, teachers, and bosses. Authority figures have power and influence that can be difficult to contradict. People are willing to believe and go along with what their superiors tell them because they trust their bosses to do the right thing. It can be difficult to hang on to your ethical principles when your boss asks you to go against them.

Lower level financial employees are often especially afraid to speak up if they see something unethical happening. They might obey unethical orders or not even realize that what they are doing is wrong. For example, let’s say your supervisor asks you to make financial projections that support the CEO’s goal to expand into new markets. However, you’ve crunched the numbers, and you aren’t sure that entering new markets will be profitable. You might find it difficult to go against your supervisor’s request because you believe s/he knows best, even though it might not seem like the ethical thing to do. Or, you might be afraid that going against your supervisor will hurt your own career.

**Conformity and Groupthink.** Finance professionals are also vulnerable to the effects of conformity and groupthink. **Conformity** is the tendency to behave in the same way that everyone else does, rather than exercising one’s own judgment. Wanting to fit in is normal—no one wants to be the recipient of negative attention! However, conformity can be dangerous when everyone is following the wrong path. You might not want to be the one person who speaks up about reckless use of capital, for example, but if you conform with everyone else, who will stop the unethical action from happening?

Groupthink is another problem that affects ethical decision-making in finance. **Groupthink** occurs when people in a group make decisions together in a way that discourages individual responsibility or creativity. Groupthink prevents people from considering other perspectives, and it often leads to poor decision-making and weakened morals. Groups with similar members who are isolated from outside opinions are particularly vulnerable to groupthink. Financial professionals, who may have similar educational and professional backgrounds to those around them, can be susceptible to this problem.

**Incrementalism.** Another obstacle that faces finance professionals is incrementalism. Incrementalism refers to the diminishing of ethical values over time. The majority of people, including finance professionals, do not intend to act unethically. However, over time, ethics can gradually begin to deplete. One small unethical action leads to more and more, until ethical principles no longer exist at all. This idea is also referred to as a “slippery slope.” Let’s say a financial analyst fudges a few numbers here and there to convince a company’s board of directors to approve a new product line. When s/he doesn’t get caught, and no negative consequences occur, s/he might be tempted to tell bigger, more frequent lies. Over time, these lies will continue to build until serious consequences occur. By that time, the financial analyst might not even remember that he once thought lying was wrong.

**Over-optimism and overconfidence.** Optimism and confidence are usually considered positive traits, but in the case of finance, there can be too much of a good thing. People are often guilty of being overly sure of themselves, particularly in their ability to act ethically. Finance professionals are no exception, particularly when they have been successful in the past. Overconfident executives are more likely to commit fraud or make other unethical decisions than others. This state of mind can blind people to their own vulnerability to unethical behavior.

**Self-interest.** It is natural to look out for yourself! Self-interest, however, can bias decision-making. It is difficult to make the ethical choice if it goes against your own wellbeing. For example, if a financial professional knows that s/he will be fired for reporting an ethical violation, it will probably be difficult for him/her to do so.

**Framing.** When it comes to ethical issues in finance, it’s all in how you look at it. Framing is the tendency to respond to situations based on how those situations are posed or viewed. The way information is presented characterizes one’s judgment and understanding of it. The same fact presented in two ways can be interpreted quite differently. For example, Leena and Hank both work in finance but for different companies. If Leena’s company stresses making a profit no matter the cost, she might see a particular decision as admissible. However, if Hank’s company focuses on ethics, he might view the same action as unacceptable.

The video “Framing” from Ethics Unwrapped explains this concept in greater detail:

<https://youtu.be/Bv3dPd2iwB4>.

**Short-term gratification.** Another factor that can lead finance professionals to unethical behavior is the desire for short-term gratification. Short-term gratification is the pursuit of instant satisfaction rather than delaying rewards for greater long-term benefit. For example, let’s say you have a big exam next week, but you want to spend time with your friends. Hanging out with your friends would bring short-term gratification because in that moment, it would make you happier to see your friends. However, while it might make you happier in the short term, it probably will not feel so good later, when you have to pull an all-nighter the evening before the exam—or when you get a less-than-satisfactory grade on the exam.

This concept affects financial professionals because it can be tempting to make a lot of money in the short term, even when the ways they do so can cause serious problems in the long term. For example, Winston might be tempted to encourage his company to make an investment that would boost its revenue this quarter, even if the investment would cause losses in the long run.

**Sunk costs.** Sunk costs are costs that have already been incurred and thus cannot be recovered. Sunk costs can affect decision-making. Consider this example: you just signed a lease on an apartment, and then discover that your new home is a lot smaller than you thought it would be. You might try to convince yourself that you don’t need more space, or that you’ll get used to it, rather than breaking the lease or admitting that you should have gone to see it before signing. The same logic can be applied to decisions made by financial professionals. If you have already invested in something, it is difficult to admit that it was not the right decision, especially when there is nothing you can do about it. Therefore, financial professionals might double down on the wrong decision and pursue it even more heavily to make themselves feel better.

**Loss aversion.** No one likes to lose. In fact, people generally dislike losing much more than they enjoy winning. Loss aversion is the tendency to avoid a loss at all costs, even when attempting to avoid that loss can lead to consequences. For example, if a financial analyst causes his/her company to lose money, s/he might try to hide the loss and engage in unethical activities to make up the difference rather than accepting that s/he made a mistake. Loss aversion can tempt financial employees to act unethically.

Finance professionals should be aware of these phenomena and how they can affect decision-making. Knowing the ways that they might be vulnerable to unethical behavior can help them to think twice and prevent detrimental consequences.

Summary

Finance is the process of obtaining funds and using them to achieve the goals of a business. It is important for financial professionals to be ethical because of the substantial impact they have on the success of companies and the economy. While some finance professionals might just be greedy, most of those who act unethically are affected by several psychological and behavioral factors. These include obedience to authority, conformity and groupthink, incrementalism, over-optimism and overconfidence, self-interest, framing, short-term gratification, sunk costs, and loss aversion. Finance professionals should be aware of these phenomena and how they can affect decision-making.

Confront Unethical Behavior

Ethical financial practices are crucial to the success of organizations and the economy, but it is not always easy to be ethical. All of the challenges might seem impossible to overcome, but financial professionals can use several techniques to ensure they are behaving ethically.

**Recognize and develop ethical traits.** Finance professionals need to be aware of **ethical principles**. People who work in finance can try to follow these principles to avoid pitfalls. Some ethical principles that are particularly applicable to finance are:

**• Fairness:** Fairness is the ability to make judgments without favoritism or self-interest. Financial professionals can demonstrate fairness by avoiding **conflicts of interest** and remaining objective.

**• Competence:** Competence is the ability to do what needs to be done. Financial professionals must be skilled, intelligent, and good at what they do. If they are not, they risk the wellbeing of the company.

**• Confidentiality:** Financial information requires some discretion to protect the company’s interests. It is important for financial professionals to keep information secret or private.

**• Integrity:** Integrity means adhering to an established set of personal ethics and sound moral principles at all times, even when it is difficult. A financial professional with strong integrity will be less tempted to engage in any sort of unethical behavior.

**• Diligence:** Diligence is careful and persistent work or effort. Financial professionals should never be careless or lazy because they will risk making mistakes and causing problems for their companies.

**• Self-regulation:** Financial professionals have a high level of accountability and personal responsibility. Therefore, they should not need to be heavily managed or scrutinized. Rather, they should take the initiative to monitor the quality of their own work.

**• Transparency:** Transparency includes maintaining open and truthful communications. Those who work in finance must be trusted to be honest, never hiding information or being afraid to speak up when necessary.

**• Rule of law:** Following the law is essential for financial professionals. Otherwise, they risk legal consequences for their entire organizations.

Most employers and financial institutions have a **code of ethics** that guide conduct in the workplace. Usually, these codes are based on ethical principles such as these. Despite the usefulness of workplace codes of ethics, however, finance professionals are likely to encounter situations that are not cut and dry. Along with a code of ethics, they should be prepared with tactics that can help guide them toward the right decision.

**Assess rationalization.** In situations where there is a conflict between what you are doing and what you know that you should be doing, you might try to **rationalize** your actions to yourself and others. It is important to be aware of when rationalization is occurring. Financial professionals who are in ethical dilemmas might find themselves thinking, “This is no big deal” or “I bet other people do this all of the time.” When thoughts like these occur, financial professionals should stop and consider whether or not their motivations are ethical. It is important to assess each possible option and be aware of the influential factors that make it difficult to do the right thing.

To learn more about the ethical decision-making process and the importance of understanding rationalization, watch the video “Being Your Best Self, Part 2: Moral Decision Making” from

Ethics Unwrapped: https://youtu.be/2mhkAUEmLVo.

**Voice your concerns.** If you have assessed the situation and believe that something unethical is occurring, it is important to voice your concerns as soon as possible. It can be difficult to speak up, but if you don’t, further consequences may result.

First, financial professionals should talk to the person or people who are directly involved in the unethical situation. A conversation can help to clarify the details of the situation and make sure that the other parties are aware of the concerns. A well thought out conversation might make them realize that their actions are unethical or give them the reminder they need to get back on track.

Finance professionals should avoid being accusatory or critical. Instead, they should ask questions and try to direct the person to see their perspectives. One conversational tactic is **playing the devil’s advocate**, which means arguing against a position for the sake of argument or to validate that argument. Playing the devil’s advocate involves looking for all possible counterpoints to an idea. It can help uncover ethical issues with a decision.

For example, let’s say your boss asks you to push forward with a merger, but you know that there are many legal issues that haven’t been addressed. Playing the devil’s advocate means bringing up all possible problems that you can see with the merger. Your boss might start to see your point of view, or perhaps s/he will listen and then reassure you that your concerns are not warranted. Either way, playing the devil’s advocate helps to protect against unforeseen ethical issues. Unfortunately, some people may not be receptive to others’ concerns, regardless of how well they are articulated. In that case, financial professionals might need to escalate the concern to a higher level executive, an ethics hotline, or even the authorities if they believe that the law has been broken. An ethical company should have a system in place for financial professionals to share their concerns in a protected and productive way.

To see how ethically questionable financial decisions can contribute to a financial crisis,

watch “The Causes and Effects of the 2008 Financial Crisis” from Cash Money Life at

https://www.youtube.com/watch?v=N9YLta5Tr2A.

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Summary

Even though there are many obstacles, there are also several ways that finance professionals can develop ethical behavior. One is becoming aware of ethical traits, such as fairness, competence, confidentiality, integrity, diligence, professionalism, self-regulation, transparency, and the rule of law. When confronted with an ethical dilemma, finance professionals should assess any rationalizations that they are making. If they determine that something unethical is occurring, they should voice their concerns to those involved. One strategy to help in this confrontation is playing the devil’s advocate. If necessary, finance professionals should take their concerns to a higher level executive, an ethics hotline, or the authorities. These tactics can help finance professionals to combat unethical issues and improve the financial health of companies, their employees and customers, and the economy.