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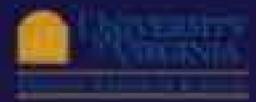

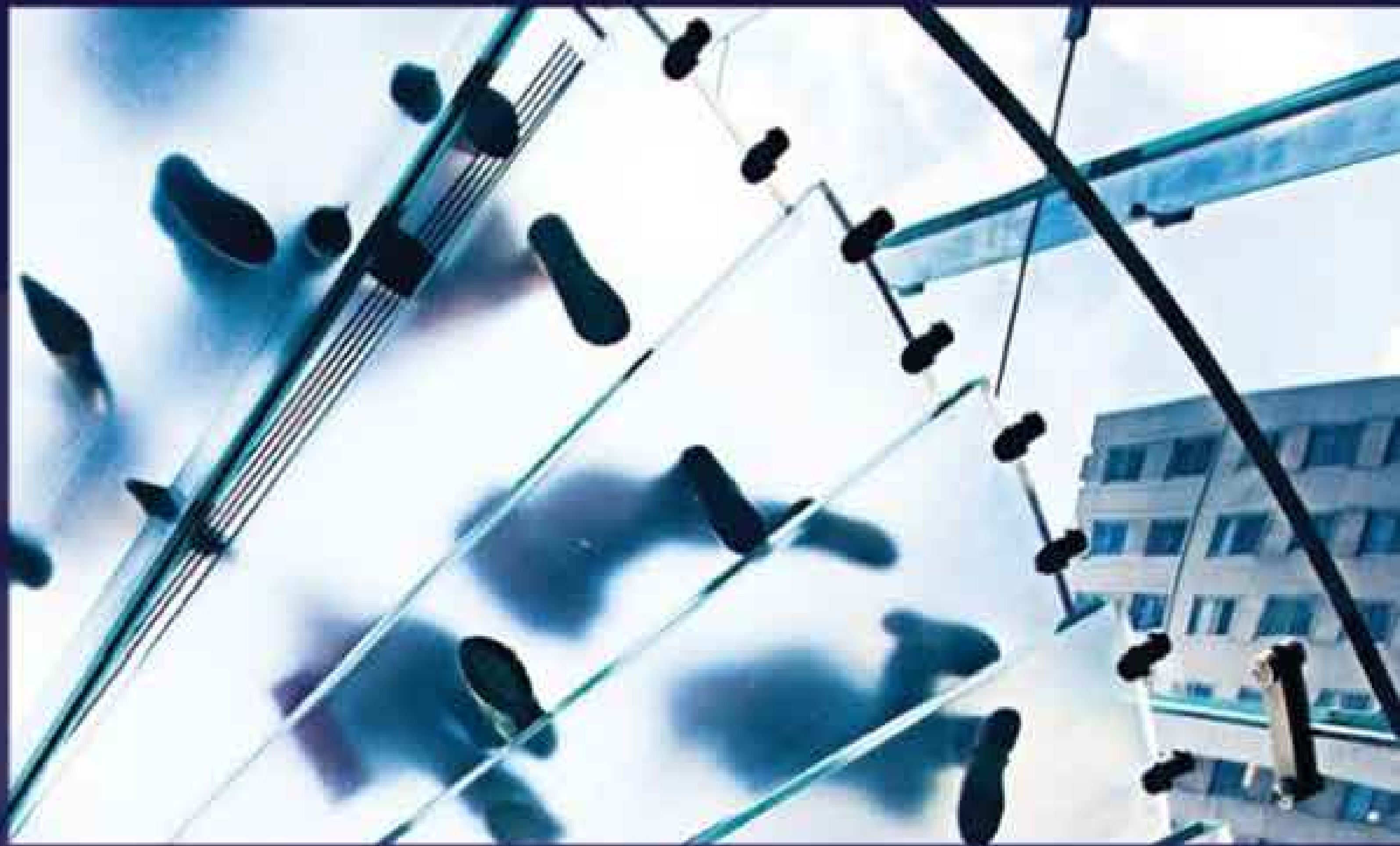

Case Studies in Finance

managing for corporate value creation

seventh edition

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Seventh Edition

Robert F. Bruner
Kenneth M. Eades
Michael J. Schill

DARDEN SCHOOL OF BUSINESS

McGraw-Hill Irwin

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CASE STUDIES IN FINANCE: MANAGING FOR CORPORATE VALUE CREATION, SEVENTH EDITION

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Dedication

In dedication to
our wives

Barbara M. Bruner
Kathy N. Eades
Mary Ann H. Schill

and to our children

About the Authors

Robert F. Bruner is Dean of the Darden Graduate School of Business Administration, Distinguished Professor of Business Administration and Charles C. Abbott Professor of Business Administration at the University of Virginia. He has taught and written in various areas, including corporate finance, mergers and acquisitions, investing in emerging markets, innovation, and technology transfer. In addition to *Case Studies in Finance,* his books include *Finance Interactive,* multimedia tutorial software in Finance (Irwin/McGraw-Hill 1997), *The Portable MBA* (Wiley 2003), *Applied Mergers and Acquisitions,* (Wiley, 2004), *Deals from Hell: M&A Lessons that Rise Above the Ashes* (Wiley, 2005) and *The Panic of 1907* (Wiley, 2007). He has been recognized in the United States and Europe for his teaching and case writing. *BusinessWeek* magazine cited him as one of the "masters of the MBA classroom." He is the author or co-author of over 400 case studies and notes. His research has been published in journals such as *Financial Management, Journal of Accounting and Economics, Journal of Applied Corporate Finance, Journal of Financial Economics, Journal of Financial and Quantitative Analysis,* and *Journal of Money, Credit, and Banking.* Industrial corporations, financial institutions, and government agencies have retained him for counsel and training. He has been on the faculty of the Darden School since 1982, and has been a visiting professor at various schools including Columbia, INSEAD, and IESE. Formerly he was a loan officer and investment analyst for First Chicago Corporation. He holds the B.A. degree from Yale University and the M.B.A. and D.B.A. degrees from Harvard University. Copies of his papers and essays may be obtained from his website, http://www.darden.virginia.edu/web/Faculty-Research/Directory/Full-time/Robert-F-Bruner/. He may be reached via email at brunerr@virginia.edu.

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Foreword

The half-decade from 2008 to 2013 forced a series of "teachable moments" into the consciousness of leaders in both business and government. More such moments may be in the offing, given the unresolved issues stemming from the global financial crisis. What lessons shall we draw from these moments? And how shall we teach the lessons so that the next generation of leaders can implement wiser policies?

One theme implicit in most critiques and policy recommendations of this period entails *the consequences of financial illiteracy*. At few other times in financial history have we seen so strong an affirmation of Derek Bok's famous argument, "If you think education is expensive, try ignorance." The actions and behavior of consumers, investors, financial intermediaries, and regulators suggest ignorance (naïve or otherwise) of such basic financial concepts as time value of money, risk-adjusted returns, cost of capital, capital adequacy, solvency, optionality, capital market efficiency, and so on. If ignorance is bliss, teachers of finance face a delirious world.

Now more than ever, the case method of teaching corporate finance is critical to meeting the diverse educational challenges of our day. The cases presented in this volume address the richness of the problems that practitioners face and help to develop the student in three critical areas:

- *Knowledge.* The conceptual and computational building blocks of finance are the necessary foundation for professional competence. The cases in this volume afford solid practice with the breadth and depth of this foundational knowledge. And they link the practical application of tools and concepts to a *contextual setting* for analysis. Such real-world linkage is an important advantage of case studies over textbook problem sets.
- *Skills.* Case studies demand decisions and recommendations. Too many analysts are content to calculate or estimate without helping a decision-maker fully understand the implications of the analysis. By placing the student in the position of the decision-maker, the case study promotes confidence and competence in making decisions. Furthermore, class discussions of cases promote skills in communication, selling and defending ideas, giving feedback, negotiating, and getting results through teamwork—these are social skills that are best learned in face-to-face engagement.
- *Attributes of character.* Popular outrage over the crisis focused on *shady ethics.* The duty of agents, diligence in the execution of professional responsibilities, breaches of trust, the temptations of self-dealing, and outright fraud intrude into retrospective assessments of what might otherwise be dry and technical analyses of the last decade. It is no longer possible or desirable to teach finance as a purely technical subject devoid of ethical considerations. Ultimately, teaching is a moral act: by choosing worthy problems, modeling behavior, and challenging the thinking of students, the teacher strengthens students in ways that are vitally important for the future of society. The case method builds attributes of character such as work ethic and persistence; empathy for classmates and decision-makers; social awareness of the consequences of decisions and the challenging context for decision-makers; and accountability for one's work. When students are challenged orally to explain their work, the ensuing discussion reveals the moral dilemmas that confront the decision maker. At the core of transformational teaching with cases is growth in integrity. As Aristotle said, "Character is destiny," a truism readily apparent in the ruinous aftermath of the global financial crisis.

As with the sixth edition of this book, I must commend my colleagues, Kenneth Eades and Michael Schill, who brought this seventh edition to the public. They are accomplished scholars in Finance and masterful teachers—above all, they are devoted to the quality of the learning experience for students. Their efforts in preparing this volume will enrich the learning for countless students and help teachers world-wide to rise to the various challenges of the post-crisis world.

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Charlottesville, Virginia
October 8, 2012

Preface

The inexplicable is all around us. So is the incomprehensible. So is the unintelligible. Interviewing Babe Ruth in 1928, I put it to him "People come and ask what's your system for hitting home runs—that so?" "Yes," said the Babe, "and all I can tell 'em is I pick a good one and sock it. I get back to the dugout and they ask me what it was I hit and I tell 'em I don't know except it looked good."*

—Carl Sandburg†

Managers are not confronted with problems that are independent of each other, but with dynamic situations that consist of complex systems of changing problems that interact with each other. I call such situations messes . . . Managers do not solve problems: they manage messes.

—Russell Ackoff‡

Orientation of the Book

Practitioners tell us that much in finance is inexplicable, incomprehensible, and unintelligible. Like Babe Ruth, their explanations for their actions often amount to "I pick a good one and sock it." Fortunately for a rising generation of practitioners, tools and concepts of Modern Finance provide a language and approach for excellent performance. The aim of this book is to illustrate and exercise the application of these tools and concepts in a messy world.

Focus on Value

The subtitle of this book is *Managing for Corporate Value Creation*. Economics teaches us that value creation should be an enduring focus of concern because value is the foundation of survival and prosperity of the enterprise. The focus on value also helps managers understand the impact of the firm on the world around it. These cases harness and exercise this economic view of the firm. It is the special province of finance to highlight value as a legitimate concern for managers. The cases in this book exercise valuation analysis over a wide range of assets, debt, equities, and options, and a wide range of perspectives, such as investor, creditor, and manager.

Linkage to Capital Markets

An important premise of these cases is that managers should take cues from the capital markets. The cases in this volume help the student learn to look at the capital markets in four ways. First, they illustrate important players in the capital markets such as individual exemplars like Warren Buffett and Bill Miller and institutions like

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*George Herman "Babe" Ruth (1895–1948) was one of the most famous players in the history of American baseball, leading the league in home runs for 10 straight seasons, setting a record of 60 home runs in one season, and hitting 714 home runs in his career. Ruth was also known as the "Sultan of Swat."

†Carl Sandburg, "Notes for Preface," in *Harvest Poems* (New York: Harcourt Brace Jovanovich, 1960), p.11.

‡Russell Ackoff, "The Future of Operational Research is Past," *Journal of Operational Research Society,* 30, 1 (Pergamon Press, Ltd., 1979): 93–104.

investment banks, commercial banks, rating agencies, hedge funds, merger arbitrageurs, private equity firms, lessors of industrial equipment, and so on. Second, they exercise the students' abilities to interpret capital market conditions across the economic cycle. Third, they explore the design of financial securities, and illuminate the use of exotic instruments in support of corporate policy. Finally, they help students understand the implications of transparency of the firm to investors, and the impact of news about the firm in an efficient market.

Respect for the Administrative Point of View

The real world is messy. Information is incomplete, arrives late, or is reported with error. The motivations of counterparties are ambiguous. Resources often fall short. These cases illustrate the immense practicality of finance theory in sorting out the issues facing managers, assessing alternatives, and illuminating the effects of any particular choice. A number of the cases in this book present practical ethical dilemmas or moral hazards facing managers—indeed, this edition features a chapter, "Ethics in Finance" right at the beginning, where ethics belongs. Most of the cases (and teaching plans in the associated instructor's manual) call for *action plans* rather than mere analyses or descriptions of a problem.

Contemporaneity

All of the cases in this book are set in the year 2000 or after and 40 percent are set in 2006 or later. A substantial proportion (25 percent) of these cases and technical notes are new, or significantly updated. The mix of cases reflects the global business environment: 45 percent of the cases in this book are set outside the United States, or have strong cross-border elements. Finally the blend of cases continues to reflect the growing role of women in managerial ranks: 28 percent of the cases present women as key protagonists and decision-makers. Generally, these cases reflect the increasingly diverse world of business participants.

Plan of the Book

The cases may be taught in many different combinations. The sequence indicated by the table of contents corresponds to course designs used at Darden. Each cluster of cases in the Table of Contents suggests a concept module, with a particular orientation.

1. **Setting Some Themes.** These cases introduce basic concepts of value creation, assessment of performance against a capital market benchmark, and capital market efficiency that reappear throughout a case course. The numerical analysis required of the student is relatively light. The synthesis of case facts into an important framework or perspective is the main challenge. The case, "Warren E. Buffett, 2005," sets the nearly universal theme of this volume: the need to think like an investor. "Bill Miller and Value Trust," explores a basic question about performance measurement: what is the right benchmark against which to evaluate success? "Ben & Jerry's Homemade, Inc." invites a consideration of "value" and the ways to measure it. The case entitled, "The Battle for Value, 2004: FedEx Corp. vs. United Parcel Service, Inc." uses

"economic profit" (or EVA®) to explore the origins of value creation and destruction, and its competitive implications for the future. A new case, "Genzyme and Relational Investors: Science and Business Collide?", poses the dilemma of managing a public company when the objectives of the shareholders are not always easily aligned with the long-term objectives of the company.

2. **Financial Analysis and Forecasting.** In this section, students are introduced to the crucial skills of financial-statement analysis, break-even analysis, ratio analysis, and financial statement forecasting. The section starts with a note, "The Thoughtful Forecaster", that provides a helpful introduction to financial statement analysis and student guidance on generating rational financial forecasts. The case, "Value Line Publishing: October 2002", provides students an exposure to financial modeling with electronic spreadsheets. "Horniman Horticulture" uses a financial model to build intuition for the relevancy of corporate cash flow and the financial effects of firm growth. The case, "Krispy Kreme Doughnuts, Inc.," confronts issues regarding the quality of reported financial results. "Guna Fibres" asks the students to consider a variety of working capital decisions, including the impact of seasonal demand upon financing needs. Other cases address issues in the analysis of working-capital management, and credit analysis.
3. **Estimating the Cost of Capital.** This module begins with a discussion of "best practices" among leading firms. The cases exercise skills in estimating the cost of capital for firms and their business segments. The cases aim to exercise and solidify students' mastery of the capital asset pricing model, the dividend-growth model, and the weighted average cost of capital formula. "Roche Holdings AG: Funding the Genentech Acquisition" is a new case that invites students to estimate the appropriate cost of debt in the largest debt issuance in history. The case provides an introduction to the concept of estimating required returns. "Nike, Inc.: Cost of Capital" presents an introductory exercise in the estimation of the weighted average cost of capital. "Teletech Corporation, 2005," explores the implications of mean-variance analysis to business segments within a firm, and gives a useful foundation for discussing value-additivity. "The Boeing 7E7," presents a dramatic exercise in the estimation of a discount rate for a major corporate project.
4. **Capital Budgeting and Resource Allocation.** The focus of these cases is the evaluation of investment opportunities and entire capital budgets. The analytical challenges range from simple time value of money problems ("The Investment Detective") to setting the entire capital budget for a resource-constrained firm ("Target Corporation"). Key issues in this module include the estimation of Free Cash Flows, the comparison of various investment criteria (NPV, IRR, payback, and equivalent annuities), the treatment of issues in mutually exclusive investments, and capital budgeting under rationing. This module features several new cases. The first is "The Procter and Gamble Company: Crest Whitestrips Advanced Seal", which asks the student to value a new product launch but then consider the financial implications of a variety of alternative launch scenarios. The second new case, "Jacobs Division", presents students an opportunity to consider the implications of strategic planning processes. And finally, "UVa Hospital System: The Long-term Acute Care Hospital Project", is an analysis of investment

decision within a not-for-profit environment. In addition to forecasting and valuing the project's cash flows, students must assess whether NPV and IRR are appropriate metrics for an organization that does not have stockholders.

5. **Management of the Firm's Equity: Dividends and Repurchases.** This module seeks to develop practical principles about dividend policy and share issues by drawing on concepts about dividend irrelevance, signaling, investor clienteles, bonding, and agency costs. The first case, "Gainesboro Machine Tools Corporation", concerns a company that is changing its business strategy and considering a change in its dividend policy. The case serves as a comprehensive introduction to corporate financial policy and themes in managing the right side of the balance sheet. The second case is new to this edition. "AutoZone, Inc." is a leading auto parts retailer that has been repurchasing shares over many years. The case serves as an excellent example of how share repurchases impact the balance sheet and presents the student with the challenge of assessing the impact upon the company's stock price.
6. **Management of the Corporate Capital Structure.** The problem of setting capital structure targets is introduced in this module. Prominent issues are the use and creation of debt tax shields, the role of industry economics and technology, the influence of corporate competitive strategy, the tradeoffs between debt policy, dividend policy, and investment goals, and the avoidance of costs of distress. The case, "California Pizza Kitchen," addresses the classic dilemma entailed in optimizing the use of debt tax shields and providing financial flexibility—this theme is extended in another case, "Deluxe Corporation" that asks how much flexibility a firm needs. "Horizon Lines, Inc." is a new case about a company facing default on a debt covenant that will prompt the need for either Chapter 11 protection or a voluntary financial restructuring.
7. **Analysis of Financing Tactics: Leases, Options, and Foreign Currency.** While the preceding module is concerned with setting debt targets, this module addresses a range of tactics a firm might use to pursue those targets, hedge risk, and exploit market opportunities. Included are domestic and international debt offerings, leases, currency hedges, warrants, and convertibles. With these cases, students will exercise techniques in securities valuation, including the use of option-pricing theory. For example, "Baker Adhesives" explores the concept of exchange-rate risk and the management of that risk with a forward-contract hedge and a money-market hedge. "MoGen, Inc" presents the pricing challenges associated with a convertible bond as well as a complex hedging strategy to change the conversion price of the convertible through the purchase of options and issuance of warrants. A new case, "J&L Railroad", presents a commodity risk problem for which students are asked to propose a specific hedging strategy using financial contracts offered on the open market or from a commercial bank.
8. **Valuing the Enterprise: Acquisitions and Buyouts.** This module begins with an extensive introduction to firm valuation in the note "Methods of Valuation: Mergers and Acquisitions." The focus of the note includes valuation using DCF and multiples. This edition features four new cases in this module. The first new case, "American Greetings", is provides a straightforward firm valuation in the context of a repurchase decision and is designed to be an introduction to firm

valuation. The second new case is “Rosetta Stone: Pricing the 2009 IPO”, provides an alternative IPO valuation case to the JetBlue case with additional focus on valuation with market multiples. “Sun Microsystems” is the third new addition to the module and presents traditional takeover valuation case with opportunities to evaluate merger synergies and cost of capital implications. Several of the cases demand an analysis that spans several stakeholders. For example, “Hershey Foods Corporation,” presents the high profile story of when the Hershey Trust Company put Hershey Foods up for sale. The case raises a number of challenging valuation and governance issues. “The Timken Company” deals with an acquisition that requires the student to conduct a challenging valuation analysis of Torrington as well as develop a financing strategy for the deal. The module also features a merger negotiation exercise (“Flinder Valves and Controls Inc.”) that provides an engaging venue for investigating the distribution of joint value in a merger negotiation. Thus, the comprehensive nature of cases in this module makes them excellent vehicles for end-of-course classes, student term papers, and/or presentations by teams of students.

This edition offers a number of cases that give insights about investing or financing decisions in emerging markets. These include “Guna Fibres Ltd.,” “Star River Electronics Ltd.,” and “Baker Adhesives.”

Summary of Changes for this Edition

The seventh edition represents a substantial change from the sixth edition.

This edition offers 13 new or significantly updated cases in this edition, or 25 percent of the total. In the interest of presenting a fresh and contemporary collection, older cases have been updated and/or replaced with new case situations such that all the cases are set in 2000 or later and 40 percent are set in 2006 or later. Several of the favorite “classic” cases from the first six editions are available online from Irwin/McGraw-Hill, from where instructors who adopt this edition may copy them for classroom use. All cases and teaching notes have been edited to sharpen the opportunities for student analysis.

The book continues with a strong international aspect (24 of the cases, 45 percent, are set outside the United States or feature significant cross-border issues). Also, the collection continues to feature female decision-makers and protagonists prominently (15, or 28 percent, of the cases).

Supplements

The case studies in this volume are supported by various resources that help make student engagement a success:

- Spreadsheet files support student and instructor preparation of the cases. They are located on the book’s website at www.mhhe.com/bruner7e
- A guide to the novice on case preparation, “Note to the Student: How to Study and Discuss Cases” in this volume.

- The instructor's resource manual provides counterparty roles for two negotiation exercises and also presents detailed discussions of case outcomes, one of which is designed to be used as second class period for the case. These supplemental materials can significantly extend student learning and expand the opportunities for classroom discussion.
- An instructor's resource manual of about 800 pages in length containing teaching notes for each case. Each teaching note includes suggested assignment questions, a hypothetical teaching plan, and a prototypical finished case analysis.
- Website addresses in many of the teaching notes. These provide a convenient avenue for updates on the performance of undisguised companies appearing in the book.
- Notes in the instructor's manual on how to design a case method course, on using computers with cases, and on preparing to teach a case.
- A companion book by Robert Bruner titled, *Socrates' Muse: Reflections on Excellence in Case Discussion Leadership* (Irwin/McGraw-Hill, 2002), is available to instructors who adopt the book for classroom use. This book offers useful tips on case method teaching.
- Several "classic" cases and their associated teaching notes were among the most popular and durable cases in previous editions of *Case Studies in Finance*. Instructors adopting this volume for classroom use may request permission to reproduce them for their courses.

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[§]Students should know that we are unable to offer any comments that would assist their preparation of these cases without the prior express request of their instructors.

Note to the Student: How to Study and Discuss Cases

Get a good idea and stay with it. Dog it and work at it until it's done, and done right.
—Walt Disney

You enroll in a "case-method" course, pick up the book of case studies or the stack of loose-leaf cases, and get ready for the first class meeting. If this is your first experience with case discussions, the odds are that you are clueless and a little anxious about how to prepare for this course. That is fairly normal, but something you should try to break through quickly in order to gain the maximum benefit from your studies. Quick breakthroughs come from a combination of good attitude, good "infrastructure," and good execution—this note offers some tips.

Good Attitude

Students learn best that which they teach themselves. Passive and mindless learning is ephemeral. Active, mindful learning simply sticks. The case method makes learning sticky by placing you in situations that require the invention of tools and concepts *in your own terms*. The most successful case-method students share a set of characteristics that drive self-teaching:

1. **Personal initiative, self-reliance:** Case studies rarely suggest how to proceed. Professors are more like guides on a long hike: They can't carry you, but they can show you the way. You must arrive at the destination under your own power. You must figure out the case on your own. To teach yourself means that you must sort ideas out in ways that make sense to you personally. To teach yourself is to give yourself two gifts: the idea you are trying to learn and greater self-confidence in your own ability to master the world.

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2. **Curiosity, a zest for exploration as an end in itself:** Richard P. Feynman, who won the Nobel Prize in Physics in 1965, was once asked whether his key discovery was worth it. He replied, "[The Nobel Prize is] a pain in the [neck]. . . . I don't like honors. . . . The prize is the pleasure of finding the thing out, the kick in the discovery, the observation that other people use it [my work]—those are the real things; the honors are unreal to me."[1]
3. **A willingness to take risks:** Risk-taking is at the heart of all learning. Usually, one learns more from failures than from successes. Banker Walter Wriston once said, "Good judgment comes from experience. Experience comes from bad judgment."
4. **Patience and persistence:** Case studies are messy, a realistic reflection of the fact that managers don't manage problems, they manage messes. Initially, reaching a solution will seem to be the major challenge. But once you reach *a* solution, you may discover other possible solutions and then face the choice among the best alternatives.
5. **An orientation to community and discussion:** Much of the power of the case method derives from a willingness to *talk* with others about your ideas and your points of confusion. This is one of the paradoxes of the case method: You must teach yourself, but not in a vacuum. The poet T. S. Eliot said, "There is no life not lived in community." Talking seems like such an inefficient method of sorting through the case, but if exploration is an end in itself, then talking is the only way. Furthermore, talking is an excellent means of testing your own mastery of ideas, of rooting out points of confusion, and, generally, of preparing yourself for professional life.
6. **Trust in the process:** The learnings from a case-method course are impressive. They arrive cumulatively over time. In many cases, the learnings continue well after the course has finished. Occasionally, those learnings hit you with the force of a tsunami. But generally, the learnings creep in quietly but powerfully like the tide. After the case course, you will look back and see that your thinking, mastery, and appreciation have changed dramatically. The key point is that you should not measure the success of your progress on the basis of any single case discussion. Trust that, in the cumulative work over many cases, you will gain the mastery you seek.

Good Infrastructure

"Infrastructure" consists of all the resources that the case-method student can call upon. Some of this is simply given to you by the professor: case studies, assignment questions, supporting references to textbooks or articles, and computer data or models. But you can go much further to help yourself. Consider these steps:

1. **Find a quiet place to study. Spend at least 90 minutes there for each case study.** Each case has subtleties to it that you will miss unless you can concentrate. After two or three visits, your quiet place will take on the attributes of a habit:

[1]Richard P. Feynman, *The Pleasure of Finding Things Out* (Cambridge, Mass.: Perseus Publishing, 1999), 12.

You will slip into a working attitude more easily. Be sure to spend enough time in the quiet place to give yourself a chance to really engage the case.

2. **Get a business dictionary.** If you are new to business and finance, some of the terms will seem foreign; if English is not your first language, *many* of the terms will seem foreign, if not bizarre. Get into the habit of looking up terms that you don't know. The benefit of this becomes cumulative.
3. **Skim a business newspaper each day, read a business magazine, follow the markets.** Reading a newspaper or magazine helps build a *context* for the case study you are trying to solve at the moment, and helps you make connections between the case study and current events. The terminology of business and finance that you see in the publications helps to reinforce your use of the dictionary, and hastens your mastery of the terms that you will see in the cases. Your learning by reading business periodicals is cumulative. Some students choose to follow a good business-news Web site on the Internet. Those Web sites have the virtue of being inexpensive and efficient, but they tend to screen too much. Having the printed publication in your hands and leafing through it help the process of *discovery,* which is the whole point of the exercise.
4. **Learn the basics of spreadsheet modeling on a computer.** Many case studies now have supporting data available for analysis in *Microsoft Excel* spreadsheet files. Analyzing the data on a computer rather than by hand both speeds up your work and extends your reach.
5. **Form a study group.** The ideas in many cases are deep; the analysis can get complex. *You will learn more and perform better in class participation by discussing the cases together in a learning team.* Your team should devote an average of an hour to each case. High-performance teams show a number of common attributes:

   a. The members commit to the success of the team.

   b. The team plans ahead, leaving time for contingencies.

   c. The team meets regularly.

   d. Team members show up for meetings and are *prepared* to contribute.

   e. There may or may not be a formal leader, but the assignments are clear. Team members meet their assigned obligations.

6. **Get to know your professor.** In the case method, students inevitably learn more from one another than from the instructor. But the teacher is part of the learning infrastructure, too: a resource to be used wisely. Never troll for answers in advance of a case discussion. Do your homework; use classmates and learning teams to clear up most of your questions so that you can focus on the meatiest issues with the teacher. Be very organized and focused about what you would like to discuss. Remember that teachers like to learn, too: If you reveal a new insight about a case or bring a clipping about a related issue in current events, both the professor and the student can gain from their time together. Ultimately, the best payoff to the professor is the "aha" in the student's eyes when he or she masters an idea.

Good Execution

Good attitude and infrastructure must be employed properly—one needs good execution. The extent to which a student learns depends on how the case study is approached. What can one do to gain the maximum from the study of those cases?

1. **Reading the case.** The very first time you read any case, look for the forest, not the trees. This requires that your first reading be quick. Do not begin taking notes on the first round; instead, read the case like a magazine article. The first few paragraphs of a well-constructed case usually say something about the problem—read those carefully. Then quickly read the rest of the case, mainly seeking a sense of the scope of the problems and what information the case contains to help resolve them. Leaf through the exhibits, looking for what information they hold rather than for any analytical insights. At the conclusion of the first pass, read any supporting articles or notes that your instructor may have recommended.
2. **Getting into the case situation. Develop your "awareness."** With the broader perspective in mind, the second and more detailed reading will be more productive. The reason is that as you now encounter details, your mind will be able to organize them in some useful fashion rather than inventorying them randomly. Making links among case details is necessary for solving the case. At this point, you can take notes that will set up your analysis.

   The most successful students project themselves into the position of the decision-maker because this perspective helps them link case details as well as develop a stand on the case problem. Assignment questions may help you do this, but it is a good idea to get into the habit of doing it yourself. Here are the kinds of questions you might try to answer in preparing every case:

   - Who are the protagonists in the case? Who must take action on the problem? What do they have at stake? What pressures are they under?
   - What business is the company in? What is the nature of its product? What is the nature of demand for that product? What is the firm's distinctive competence? With whom does it compete?[2] What is the structure of the industry? Is the firm comparatively strong or weak? In what ways?
   - What are the goals of the firm? What is the firm's strategy in pursuit of those goals? (The goals and strategy may be explicitly stated, or they may be implicit in the way the firm does business.) What are the firm's apparent functional policies in marketing (e.g., push versus pull strategy), production (e.g., labor relations, use of new technology, distributed production versus centralized), and finance (e.g., the use of debt financing, payment of dividends)? Financial

[2]Think broadly about competitors. In *A Connecticut Yankee in King Arthur's Court,* Mark Twain wrote, "The best swordsman in the world doesn't need to fear the second best swordsman in the world; no, the person for him to be afraid of is some ignorant antagonist who has never had a sword in his hand before; he doesn't do the thing he ought to do, and so the expert isn't prepared for him; he does the thing he ought not to do; and it often catches the expert out and ends him on the spot."

and business strategies can be inferred from an analysis of the financial ratios and a sources-and-uses-of-funds statement.

- How well has the firm performed in pursuit of its goals? (The answer to this question calls for simple analysis using financial ratios, such as the DuPont system, compound growth rates, and measures of value creation.)

  The larger point of this phase of your case preparation is to broaden your awareness of the issues. Warren Buffett, perhaps the most successful investor in history, said, "Any player unaware of the fool in the market probably *is* the fool in the market." Awareness is an important attribute of successful managers.

3. **Defining the problem.** A common trap for many executives is to assume that the issue at hand is the real problem most worthy of their time, rather than a symptom of some larger problem that *really* deserves their time. For instance, a lender is often asked to advance funds to help tide a firm over a cash shortfall. Careful study may reveal that the key problem is not a cash shortfall, but rather product obsolescence, unexpected competition, or careless cost management. Even in cases where the decision is fairly narrowly defined (e.g., a capital-expenditure choice), the "problem" generally turns out to be the believability of certain key assumptions. Students who are new to the case method tend to focus narrowly in defining problems and often overlook the influence that the larger setting has on the problem. In doing that, the student develops narrow specialist habits, never achieving the general-manager perspective. It is useful and important for you to define the problem yourself and, in the process, validate the problem as suggested by the protagonist in the case.
4. **Analysis: run the numbers and go to the heart of the matter.** Virtually all finance cases require numerical analysis. This is good because figure-work lends rigor and structure to your thinking. But some cases, reflecting reality, invite you to explore blind alleys. If you are new to finance, even those explorations will help you learn.[3] The best case students develop an instinct for where to devote their analysis. Economy of effort is desirable. If you have invested wisely in problem definition, economical analysis tends to follow. For instance, a student might assume that a particular case is meant to exercise financial forecasting skills and will spend two or more hours preparing a detailed forecast, instead of preparing a simpler forecast in one hour and conducting a sensitivity analysis based on key assumptions in the next hour. An executive rarely thinks of a situation as having to do with a forecasting method or discounting or any other technique, but rather thinks of it as a problem of judgment, deciding on which people or concepts or environmental conditions to bet. The best case analyses get down to the *key bets* on which the executive is wagering the prosperity of the firm and his or her career. Get to the business issues quickly, and avoid lengthy churning through relatively unimportant calculations.

[3]Case analysis is often iterative: An understanding of the big issues invites an analysis of details—then the details may restructure the big issues and invite the analysis of other details. In some cases, getting to the heart of the matter will mean just such iteration.

5. **Prepare to participate: take a stand.** To develop analytical insights without making recommendations is useless to executives and drains the case-study experience of some of its learning power. A stand means having a point of view about the problem, a recommendation, and an analysis to back up both of them. The lessons most worth learning all come from taking a stand. From that truth flows the educative force of the case method. In the typical case, the student is projected into the position of an executive who must do something in response to a problem. It is this choice of what to do that constitutes the executive's stand. Over the course of a career, an executive who takes stands gains wisdom. If the stand provides an effective resolution of the problem, so much the better for all concerned. If it does not, however, the wise executive analyzes the reasons for the failure and may learn even more than from a success. As Theodore Roosevelt wrote:

    > The credit belongs to the man[4] who is actually in the arena—whose face is marred by dust and sweat and blood . . . who knows the great enthusiasms, the great devotions—and spends himself in a worthy cause—who, at best, if he wins, knows the thrills of high achievement—and if he fails, at least fails while daring greatly so that his place shall never be with those cold and timid souls who know neither victory nor defeat.

6. **In class: participate actively in support of your conclusions, but be open to new insights.** Of course, one can have a stand without the world being any wiser. To take a stand in case discussions means to participate actively in the discussion and to advocate your stand until new facts or analyses emerge to warrant a change.[5] Learning by the case method is not a spectator sport. A classic error many students make is to bring into the case-method classroom the habits of the lecture hall (i.e., passively absorbing what other people say). These habits fail miserably in the case-method classroom because they only guarantee that one absorbs the truths and fallacies uttered by others. The purpose of case study is to develop and exercise one's *own* skills and judgment. This takes practice and participation, just as in a sport. Here are two good general suggestions: (1) defer significant note-taking until after class and (2) strive to contribute to every case discussion.
7. **Immediately after class: jot down notes, corrections, and questions.** Don't overinvest in taking notes during class—that just cannibalizes "air time" in which you could be learning through discussing the case. But immediately after class, collect your learnings and questions in notes that will capture your thinking. Of course, ask a fellow student or your teacher questions to help clarify issues that still puzzle you.

[4]Today, a statement such as this would surely recognize women as well.

[5]There is a difference between taking a stand and pigheadedness. Nothing is served by clinging to your stand to the bitter end in the face of better analysis or common sense. Good managers recognize new facts and good arguments as they come to light and adapt.

8. **Once a week, flip through notes. Make a list of your questions, and pursue answers.** Take an hour each weekend to review your notes from class discussions during the past week. This will help build your grasp of the flow of the course. Studying a subject by the case method is like building a large picture with small mosaic tiles. It helps to step back to see the big picture. But the main objective should be to make an inventory of anything you are unclear about: terms, concepts, and calculations. Work your way through this inventory with classmates, learning teams, and, ultimately, the instructor. This kind of review and follow-up builds your self-confidence and prepares you to participate more effectively in future case discussions.

Conclusion: Focus on Process and Results Will Follow

View the case-method experience as a series of opportunities to test your mastery of techniques and your business judgment. If you seek a list of axioms to be etched in stone, you are bound to disappoint yourself. As in real life, there are virtually no "right" answers to these cases in the sense that a scientific or engineering problem has an exact solution. Jeff Milman has said, "The answers worth getting are never found in the back of the book." What matters is that you obtain a way of thinking about business situations that you can carry from one job (or career) to the next. In the case method, it is largely true that *how you learn is what you learn.*[6]

[6]In describing the work of case teachers, John H. McArthur has said, "How we teach is what we teach."

Ethics in Finance

The first thing is character, before money or anything else.
—J. P. Morgan (in testimony before the U.S. Congress)

The professional concerns himself with doing the right thing rather than making money, knowing that the profit takes care of itself if the other things are attended to.
—Edwin LeFevre, *Reminiscences of a Stock Operator*

Integrity is paramount for a successful career in finance and business, as practitioners remind us. One learns, rather than inherits, integrity. And the lessons are everywhere, even in case studies about finance. To some people, the world of finance is purely mechanical, devoid of ethical considerations. The reality is that ethical issues are pervasive in finance. **Exhibit 1** gives a list of prominent business scandals around the turn of the twenty-first century. One is struck by the wide variety of industrial settings and especially by the recurrent issues rooted in finance and accounting. Still, the disbelief that ethics matter in finance can take many forms.

"It's not my job," says one person, thinking that a concern for ethics belongs to a CEO, an ombudsperson, or a lawyer. But if you passively let someone else do your thinking, you expose yourself to complicity in the unethical decisions of others. Even worse is the possibility that if everyone assumes that someone else owns the job of ethical practice, then perhaps *no one* owns it and that therefore the enterprise has no moral compass at all.

Another person says, "When in Rome, do as the Romans do. It's a dog-eat-dog world. We have to play the game their way if we mean to do business there." Under that view, it is assumed that everybody acts ethically relative to his local environment so that it is inappropriate to challenge unethical behavior. This is moral relativism. The problem with this view is that it presupposes that you have no identity, that, like a chameleon, you are defined by the environment around you. Relativism is the enemy

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of personal identity and character. You *must* have a view, if you are rooted in any cultural system. Prepare to take a stand.

A third person says, "It's too complicated. Civilization has been arguing about ethics for 3,000 years. You expect me to master it in my lifetime?" The response must be that we use complicated systems dozens of times each day without a full mastery of their details. Perhaps the alternative would be to live in a cave, which is a simpler life but much less rewarding. Moreover, as courts have been telling the business world for centuries, ignorance of the law is no defense. If you want to succeed in the field of finance, you must grasp the norms of ethical behavior.

There is no escaping the fact that ethical reasoning is vital to the practice of business and finance. Tools and concepts of ethical reasoning belong in the financial toolkit alongside other valuable instruments of financial practice.

Ethics and economics were once tightly interwoven. The patriarch of economics, Adam Smith, was actually a scholar of moral philosophy. Although the two fields may have diverged in the last century, they remain strong complements.[1] Morality concerns norms and teachings. Ethics concerns the process of making morally *good* decisions or, as Andrew Wicks wrote, "Ethics has to do with pursuing—and achieving—laudable ends."[2] The *Oxford English Dictionary* defines moral as follows: "Of knowledge, opinions, judgments, etc.; relating to the nature and application of the distinction between right and wrong."[3] Ethics, however, is defined as the "science of morals."[4] To see how the decision-making processes in finance have ethical implications, consider the following case study.

Minicase: WorldCom Inc.[5]

The largest corporate fraud in history entailed the falsification of $11 billion in operating profits at WorldCom Inc. WorldCom was among the three largest long-distance telecommunications providers in the United States, the creation of a rollup acquisition strategy by its CEO, Bernard Ebbers. WorldCom's largest acquisition, MCI Communications in 1998, capped the momentum-growth story. This, combined with the buoyant stock market of the late 1990s, increased the firm's share price dramatically.

By early 2001, it dawned on analysts and investors that the United States was greatly oversupplied with long-distance telecommunications capacity. Much of that capacity had been put in place with unrealistic expectations of growth in Internet use. With the collapse of the Internet bubble, the future of telecom providers was suddenly in doubt.

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[1]Sen (1987) and Werhane (1999) have argued that Smith's masterpiece, *Wealth of Nations,* is incorrectly construed as a justification for self-interest and that it speaks more broadly about virtues such as prudence, fairness, and cooperation.

[2]Wicks (2003), 5.

[3]*Oxford English Dictionary* (1989), vol. IX, 1068.

[4]*Oxford English Dictionary* (1989), vol. V, 421.

[5]This case is based on facts drawn from Pulliam (2003), Blumenstein and Pulliam (2003), Blumenstein and Solomon (2003), and Solomon (2003).

WorldCom had leased a significant portion of its capacity to both Internet service providers and telecom service providers. Many of those lessees declined and, starting in 2000, entered bankruptcy. In mid-2000, Ebbers and WorldCom's chief financial officer (CFO), Scott Sullivan, advised Wall Street that earnings would fall below expectations. WorldCom's costs were largely fixed—the firm had high operating leverage. With relatively small declines in revenue, earnings would decline sharply. In the third quarter of 2000, WorldCom was hit with $685 million in write-offs as its customers defaulted on capacity-lease commitments. In October 2000, Sullivan pressured three midlevel accounting managers at WorldCom to draw on reserve accounts set aside for other purposes to cover operating expenses, which reduced the reported operating expenses and increased profits. The transfer violated rules regarding the independence and purpose of reserve accounts. The three accounting managers acquiesced, but later regretted their action. They considered resigning, but were persuaded to remain with the firm through its earnings crisis. They hoped or believed that a turnaround in the firm's business would make their action an exception.

Conditions worsened in the first quarter of 2001. Revenue fell further, producing a profit shortfall of $771 million. Again, Sullivan prevailed on the three accounting managers to shift operating costs—this time, to capital-expenditure accounts. Again, the managers complied. This time, they backdated entries in the process. In the second, third, and fourth quarters of 2001, they transferred $560 million, $743 million, and $941 million, respectively. In the first quarter of 2002, they transferred $818 million.

The three accounting managers experienced deep emotional distress over their actions. In April 2002, when they discovered that WorldCom's financial plan for 2002 implied that the transfers would continue until the end of the year, the three managers vowed to cease making transfers and to look for new jobs. But inquiries by the U.S. Securities and Exchange Commission (SEC) into the firm's suspiciously positive financial performance triggered an investigation by the firm's head of internal auditing. Feeling the heat of the investigation, the three managers met with representatives from the SEC, the U.S. Federal Bureau of Investigation (FBI), and the U.S. attorney's office on June 24, 2002. The next day, WorldCom's internal auditor disclosed to the SEC the discovery of $3.8 billion in fraudulent accounting. On June 26, the SEC charged WorldCom with fraud.

But the scope of the fraud grew. In addition to the $3.8 billion reallocation of operating expenses to reserves and capital expenditures, WorldCom had shifted another $7.2 billion to its MCI subsidiary, which affected the tracking stock on that entity.

As news of the size of the fraud spread, WorldCom's stock price sank. From its peak in late 2000 until it filed for bankruptcy in July 2002, about $180 billion of WorldCom's equity-market value evaporated. In March 2003, WorldCom announced that it would write off $79.8 billion in assets following an impairment analysis: $45 billion of the write-off arose from the impairment of goodwill.

The three accounting managers had hoped that they would be viewed simply as witnesses. On August 1, they were named by the U.S. attorney's office as unindicted co-conspirators in the fraud. WorldCom fired them immediately. Unable to cope with the prospect of large legal bills for their defense, they pleaded guilty to securities

fraud and conspiracy to commit fraud. The charges carried a maximum of 15 years in prison.

Bernard Ebbers and Scott Sullivan were charged with fraud. A study conducted by the bankruptcy examiner concluded that Ebbers had played a role in inflating the firm's revenues. One example cited in the report was the firm's announcement of the acquisition of Intermedia Communications Inc. in February 2001. Even before WorldCom's board had approved the deal, the firm's lawyers made it look as if the board had approved the deal by creating false minutes.

WorldCom emerged from bankruptcy in 2004 with a new name, MCI Communications. On March 2, 2004, Sullivan pleaded guilty to fraud. Ebbers continued to protest his innocence, arguing that the fraud was masterminded by Sullivan without Ebbers's knowledge. A jury found Ebbers guilty on March 15, 2005. In the summer of 2005, MCI agreed to be acquired by Verizon, a large regional telephone company in the United States.

This case illustrates how unethical behavior escalates over time. Such behavior is costly to companies, investors, and employees. It damages investor confidence and trust—and it is invariably uncovered. Fraud and earnings management share a common soil: a culture of aggressive growth. Although growth is one of the foremost aims in business, the mentality of growth at any price can warp the thinking of otherwise honorable people.

The shields against fraud are a culture of integrity, strong governance, and strong financial monitoring. Yet in some circumstances, such shields fail to forestall unethical behavior. Michael Jensen (2005) explored an important circumstance associated with managerial actions: when the stock price of a firm is inflated beyond its intrinsic (or true) value. Jensen pointed to the scandals that surfaced during and after a period of overvaluation in share prices between 1998 and 2001. He argued that "society seems to overvalue what is new." When a firm's equity becomes overvalued, it motivates behavior that poorly serves the interests of those investors on whose behalf the firm is managed. Managers whose compensation is tied to increases in share price are motivated to "game the system" by setting targets and managing earnings in ways that yield large bonuses. This behavior is a subset of problems originating from target-based corporate-budgeting systems.

Jensen argues that the market for corporate control solves the problem of *under*valued equity (i.e., firms operating at low rates of efficiency) with the instruments of hostile takeovers, proxy fights, leveraged buyouts, and so on. But he points out that there is little remedy for the opposite case, *over*valued equity. Equity-based compensation—in the form of stock options, shares of stock, stock-appreciation rights, and so on—merely adds fuel to the fire.

Paradoxically, a high stock price would seem to be desirable. But occasionally, stock prices become detached from the fundamental basis for their valuation—that is, when the price exceeds the intrinsic value of the shares. Jensen defines overvalued stock as occurring when the performance necessary to produce that price cannot be attained except by good fortune. The problem is that managers fail to face the facts and explain to investors the overvaluation of shares. Instead, they take actions that prolong, or even worsen, the overvaluation. Those actions destroy value in the long

run, even though they may appear to create or preserve value in the short run—as was the case with WorldCom. A little of this behavior begins to stimulate more; soon, a sense of proportion is lost and the organization eventually turns to fraud. The hope is to postpone the inevitable correction in price until after the executive has moved on to another firm or retired. Telling the truth to investors about overvaluation is extremely painful. The firm's stock price falls, executive bonuses dwindle, and the directors listen to outraged investors.

What the tragedies of WorldCom and the other firms cited in **Exhibit 1** share is that, like Peter Pan, those companies refused to grow up. They refused to admit frankly to their shareholders and to themselves that their very high rates of growth were unsustainable.

Why One Should Care about Ethics in Finance

Managing in ethical ways is not merely about avoiding bad outcomes. There are at least five positive arguments for bringing ethics to bear on financial decision-making.

Sustainability. Unethical practices are not a foundation for enduring, sustainable enterprise. This first consideration focuses on the *legacy* one creates through one's financial transactions. What legacy do you want to leave? To incorporate ethics into our finance mind-set is to think about the kind of world that we would like to live in and that our children will inherit.

One might object that, in a totally anarchic world, unethical behavior might be the only path in life. But this view only begs the point: We don't live in such a world. Instead, our world of norms and laws ensures a corrective process against unethical behavior.

Ethical behavior builds trust. Trust rewards. The branding of products seeks to create a bond between producer and consumer: a signal of purity, performance, or other attributes of quality. This bond is built by trustworthy behavior. As markets reveal, successfully branded products command a premium price. Bonds of trust tend to pay. If the field of finance were purely a world of one-off transactions, it would seem ripe for opportunistic behavior. But in the case of repeated entry into financial markets and transactions by, for example, active buyers, intermediaries, and advisers, reputation can count for a great deal in shaping the expectations of counterparties. This implicit bond, trust, or reputation can translate into more effective and economically attractive financial transactions and policies.

Surely, ethical behavior should be an end in itself. If you are behaving ethically only to get rich, then you are hardly committed to that behavior. But it is a useful encouragement that ethical behavior need not entail pure sacrifice. Some might even see ethical behavior as an imperfect means by which justice expresses itself.

Ethical behavior builds teams and leadership, which underpin process excellence. Standards of global best-practice emphasize that good business processes drive good outcomes. Stronger teams and leaders result in more agile and creative responses to problems. Ethical behavior contributes to the strength of teams and leadership by aligning employees around shared values and by building confidence and loyalty.

An objection to this argument is that, in some settings, promoting ethical behavior is no guarantee of team-building. Indeed, teams might blow apart over disagreements about what is ethical or what action is appropriate to take. But typically, this is not the fault of ethics, but rather that of the teams' processes for handling disagreements.

Ethics sets a higher standard than laws and regulations. To a large extent, the law is a crude instrument. It tends to trail rather than anticipate behavior. It contains gaps that become recreational exploitation for the aggressive businessperson. Justice may be neither swift nor proportional to the crime; as Andrew Wicks said, it "puts you in an adversarial posture with respect to others, which may be counterproductive to other objectives in facing a crisis."[6] To use only the law as a basis for ethical thinking is to settle for the lowest common denominator of social norms. As Richard Breeden, the former SEC chair, said, "It is not an adequate ethical standard to want to get through the day without being indicted."[7]

Some might object to that line of thinking by claiming that, in a pluralistic society, the law is the only baseline of norms on which society can agree. Therefore, isn't the law a "good-enough" guide to ethical behavior? Lynn Paine argued that this view leads to a "compliance" mentality and that ethics takes one further. She wrote, "Attention to law, as an important source of managers' rights and responsibilities, is integral to, but not a substitute for, the ethical point of view—a point of view that is attentive to rights, responsibilities, relationships, opportunities to improve and enhance human well-being, and virtue and moral excellence."[8]

Reputation and conscience. Motivating ethical behavior only by trumpeting its financial benefits without discussing its costs is inappropriate. By some estimates, the average annual income for a lifetime of crime (even counting years spent in prison) is large—it seems that crime *does* pay. If income were all that mattered, most of us would switch to this lucrative field. The business world features enough cheats and scoundrels who illustrate that there are myriad opportunities for any professional to break promises—or worse—for money. Ethical professionals decline those opportunities for reasons having to do with the kind of people they want to be. Amar Bhide and Howard Stevenson wrote:

> The businesspeople we interviewed set great store on the regard of their family, friends, and the community at large. They valued their reputations, not for some nebulous financial gain but because they took pride in their good names. Even more important, since outsiders cannot easily judge trustworthiness, businesspeople seem guided by their inner voices, by their consciences. . . . We keep promises because it is right to do so, not because it is good business.[9]

[6]Wicks (2003), 11.

[7]K. V. Salwen, "SEC Chief's Criticism of Ex-Managers of Salomon Suggests Civil Action is Likely," *Wall Street Journal,* 20 November 1991, A10.

[8]Paine (1999), 194–195.

[9]Bhide and Stevenson (1990), 127–128.

For Whose Interests Are You Working?

Generally, the financial executive or deal designer is an agent acting on behalf of others. For whom are you the agent? Two classic schools of thought emerge.

- *Stockholders*. Some national legal frameworks require directors and managers to operate a company in the interests of its shareholders. This shareholder focus affords a clear objective: do what creates shareholder wealth. This approach would seem to limit charitable giving, "living-wage" programs, voluntary reduction of pollution, and enlargement of pension benefits for retirees, all of which can be loosely gathered under the umbrella of the social responsibility movement in business. Milton Friedman (1962), perhaps the most prominent exponent of the stockholder school of thought, has argued that the objective of business is to return value to its owners, and that to divert the objective to other ends is to expropriate shareholder value and threaten the survival of the enterprise. Also, the stockholder view would argue that, if all the companies deviated, the price system would cease to function well as a carrier of information about the allocation of resources in the economy. The stockholder view is perhaps dominant in the United States, the United Kingdom, and other countries in the Anglo-Saxon sphere.
- *Stakeholders*. The alternative view admits that stockholders are an important constituency of the firm, but that other groups such as employees, customers, suppliers, and the community also have a stake in the activities and the success of the firm. Edward Freeman (1984) argued that the firm should be managed in the interest of the broader spectrum of constituents. The manager would necessarily be obligated to account for the interests and concerns of the various constituent groups in arriving at business decisions. The aim would be to satisfy them all, or at least the most concerned stakeholders, on each issue. The complexity of that kind of decision-making can be daunting and slows the process. In addition, it is not always clear which stakeholder interests are relevant in making specific decisions. Such a definition seems to depend largely on the specific context, which would seem to challenge the ability to achieve equitable treatment of different stakeholder groups across time. But the important contribution of this view is to suggest a relational view of the firm and to stimulate the manager to consider the diversity of those relationships.

Adding complexity to the question of whose interests one serves is the fact that one often has many allegiances—not only to the firm or the client, but also to one's community, family, etc. One's obligations as an employee or as a professional are only a subset of one's total obligations.

What is "Good"? Consequences, Duties, Virtues

One confronts ethical issues when one must choose among alternatives on the basis of right versus wrong. The ethical choices may be stark where one alternative is truly right and the other truly wrong. But in professional life, the alternatives typically differ

more subtly, as in choosing which alternative is *more* right or *less* wrong. Ernest Hemingway said that what is moral is what makes one feel good after and what is immoral is what makes one feel bad after. Because feelings about an action could vary tremendously from one person to the next, this simplistic test would seem to admit moral relativism as the only course, an ethical "I'm OK, you're OK" approach. Fortunately 3,000 years of moral reasoning provide frameworks for a better definition of what is right and wrong.

Right and wrong as defined by consequences. An easy point of departure is to focus on outcomes. An action might be weighed in terms of its utility[10] for society. Who is hurt or helped must be taken into consideration. Utility can be assessed in terms of the pleasure or pain for people. People choose to maximize utility. Therefore, the right action is that which produces the greatest good for the greatest number of people.

Utilitarianism has proven to be a controversial ideal. Some critics have argued that this approach might endorse gross violations of the norms that society holds dear, including the right to privacy, the sanctity of contracts, and property rights, when weighed against the consequences for all. And the calculation of utility might be subject to special circumstances or open to interpretation, making the assessment rather more situation-specific than some philosophers could accept.

Utilitarianism was the foundation for modern neoclassical economics. Utility has proved to be difficult to measure rigorously, and remains a largely theoretical idea. Yet utility-based theories are at the core of welfare economics, and underpin analyses of such widely varying phenomena as government policies, consumer preferences, and investor behavior.

Right and wrong as defined by duty or intentions. Immoral actions are ultimately self-defeating. The practice of writing bad checks, for instance, if practiced universally, would result in a world without check-writing and probably very little credit, too. Therefore, you should act on rules that you would be required to apply universally.[11] You should treat a person as an end, never as a means. It is vital to ask whether an action would show respect for others and whether that action was something a rational person would do: "If everyone behaved this way, what kind of world would we have?"

Critics of that perspective argue that its universal view is too demanding, indeed, even impossible for a businessperson to observe. For instance, the profit motive focuses on the manager's duty to just one company. But Norman Bowie responds, "Perhaps focusing on issues other than profits . . . will actually enhance the bottom line. . . . Perhaps we should view profits as a consequence of good business practices rather than as the goal of business."[12]

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[10]The Utilitarian philosophers, Jeremy Bentham (1748–1832), James Mill (1773–1836), and John Stuart Mill (1806–1873), argued that the utility (or usefulness) of ideas, actions, and institutions could be measured in terms of their consequences.

[11]The philosopher Immanuel Kant (1724–1804) sought a foundation for ethics in the purity of one's motives.

[12]Bowie (1999), 13.

Right and wrong as defined by virtues. Finally, a third tradition[13] in philosophy argues that the debate over values is misplaced. The focus should instead, be on *virtues* and the qualities of the practitioner. The attention to consequences or duty is fundamentally a focus on *compliance*. Rather, one should consider whether an action is consistent with being a virtuous person. This view argues that personal happiness flowed from being virtuous and not merely from comfort (utility) or observance (duty). It acknowledges that vices are corrupting. And it focuses on personal pride: "If I take this action, would I be proud of what I see in the mirror? If it were reported tomorrow in the newspaper, would I be proud of myself?" Warren Buffett, chief executive officer (CEO) of Berkshire Hathaway, and one of the most successful investors in modern history, issued a letter to each of his operating managers every year emphasizing the importance of personal integrity. He said that Berkshire could afford financial losses, but not losses in reputation. He also wrote, "Make sure everything you do can be reported on the front page of your local newspaper written by an unfriendly, but intelligent reporter."[14]

Critics of virtue-based ethics raise two objections. First, a virtue to one person may be a vice to another. Solomon (1999) points out that Confucius and Friedrich Nietzsche, two other virtue ethicists, held radically different visions of virtue. Confucius extolled such virtues as respect and piety, whereas Nietzsche extolled risk-taking, war-making, and ingenuity. Thus, virtue ethics may be context-specific. Second, virtues can change over time. What may have been regarded as gentlemanly behavior in the nineteenth century might have been seen by feminists in the late twentieth century as insincere and manipulative.

A discrete definition of right and wrong remains the subject of ongoing discourse. But the practical person can abstract from those and other perspectives useful guidelines toward ethical conduct:

- How will my action affect others? What are the consequences?
- What are my motives? What is my duty here? How does this decision affect them?
- Does this action serve the best that I can be?

What Can *You* Do to Promote Ethical Behavior in Your Firm?

An important contributor to unethical business practices is the existence of a work environment that promotes such behavior. Leaders in corporate workplaces need to be proactive in shaping a high-performance culture that sets high ethical expectations. The leader can take a number of steps to shape an ethical culture.

Adopt a code of ethics. One dimension of ethical behavior is to acknowledge some code by which one intends to live. Corporations, too, can adopt codes of conduct that shape ethical expectations. Firms recognize the "problem of the commons" inherent in

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[13]This view originated in ancient Greek philosophy, starting with Socrates, Plato, and Aristotle.

[14]Russ Banham, "The Warren Buffett School," *Chief Executive* (December 2002): http://www.robertpmiles.com/BuffettSchool.htm (accessed on 19 May 2003).

unethical behavior by one or a few employees. In 1909, the U.S. Supreme Court decided that a corporation could be held liable for the actions of its employees.[15] Since then, companies have sought to set corporate expectations for employee behavior, including codes of ethics.[16] **Exhibit 2** gives an example of one such code, from General Electric Company. Those norms are one page of a 35-page document outlining the code, to whom it applies, special responsibilities for employees and leaders, specific codes of conduct with respect to customers and suppliers, government business, competition, health, safety, employment, and the protection of GE's assets. Corporate codes are viewed by some critics as cynical efforts that seem merely to respond to executive liability that might arise from white-collar and other economic crimes. Companies and their executives may be held liable for an employee's behavior, even if the employee acted contrary to the company's instructions. Mere observance of guidelines in order to reduce liability is a legalistic approach to ethical behavior. Instead, Lynn Paine (1994) has urged firms to adopt an "integrity strategy" that uses ethics as the driving force within a corporation. Deeply held values would become the foundation for decision-making across the firm, and would yield a frame of reference that would integrate functions and businesses. By that view, ethics defines what a firm stands for.

In addition, an industry or a professional group can adopt a code of ethics. One example relevant to finance professionals is the Code of Ethics of the CFA Institute, the group that confers the Chartered Financial Analyst (CFA) designation on professional securities analysts and portfolio managers. Excerpts from the CFA Institute's Code of Ethics and Standards of Professional Conduct are given in **Exhibit 3.**

Talk about ethics within your team and firm. Many firms seek to reinforce a culture of integrity with a program of seminars and training in ethical reasoning. A leader can stimulate reflection through informal discussion of ethical developments (for example: indictments, convictions, civil lawsuits) in the industry or profession, or of ethical issues that the team may be facing. This kind of discussion (without preaching) signals that it is on the leader's mind and is a legitimate focus of discussion. One executive regularly raises issues such as those informally over lunch or morning coffee. Leaders believe that ethical matters are important enough to be the focus of team discussions.

Reflect on your dilemmas. The challenge for many finance practitioners is that ethical dilemmas do not readily lend themselves to the structured analysis that one would apply to valuing a firm or balancing the books. Nevertheless, one can harness the questions raised in the field of ethics to lend some rigor to one's reflections. Laura Nash (1981) abstracted a list of 12 questions on which the thoughtful practitioner might reflect in grappling with an ethical dilemma:

1. Have I defined the problem correctly and accurately?
2. If I stood on the other side of the problem, how would I define it?

[15]See *New York Central v. United States,* 212 U.S. 481.

[16]Murphy (1997) compiled 80 exemplary ethics statements.

3. What are the origins of this dilemma?
4. To whom and to what am I loyal, as a person and as a member of a firm?
5. What is my intention in making this decision?
6. How do the likely results compare with my intention?
7. Can my decision injure anyone? How?
8. Can I engage the affected parties in my decision before I decide or take action?
9. Am I confident that my decision will be as valid over a long period as it may seem at this moment?
10. If my boss, the CEO, the directors, my family, or the community learned about this decision, would I have misgivings about my actions?
11. What signals (or symbols) might my decision convey, if my decision were understood correctly? If misunderstood?
12. Are there exceptions to my position, perhaps special circumstances under which I might make a different decision?

Act on Your Reflections

This may be the toughest step of all. The field of ethics can lend structure to one's thinking, but has less to say about the action to be taken. When confronting a problem of ethics within a team or an organization, one can consider a hierarchy of responses, from questioning and coaching to whistle-blowing (either to an internal ombudsperson or, if necessary, to an outside entity) and, possibly, leaving the organization.

Conclusion

An analysis of finance's ethical issues is vital. The cases of WorldCom and other major business scandals show that ethical issues pervade the financial environment. Ethics is one of the pillars on which stands success in finance—it builds sustainable enterprise, trust, organizational strength, and personal satisfaction. Therefore, the financial decision-maker must learn to identify, analyze, and act on the ethical issues that may arise. Consequences, duties, and virtues stand out as three important benchmarks for ethical analysis. Nevertheless, the results of such analysis are rarely clear-cut. But real business leaders will take the time to sort through the ambiguities and do "the right thing" in the words of Edwin LeFevre. These and other ethical themes will appear throughout finance case studies and one's career.

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EXHIBIT 1 | Prominent Business Scandals Revealed between 1998 and 2002

The companies and their alleged or admitted accounting issues are as follows:

- Adelphia (loans and looting)
- Bristol-Myers (improper inflation of revenues through sue of sales incentives)
- CMS Energy (overstatement of revenues through round-trip energy trades)
- Computer Associates (inflation of revenues)
- Dynegy (artificial increase of cash flow)
- Elan (use of off-balance-sheet entities)
- Enron (inflation of earnings and use of off-balance-sheet entities)
- Global Crossing (artificial inflation of revenues)
- Halliburton (improper revenue recognition)
- Kmart (accounting for vendor allowances)
- Lucent Technologies (revenue accounting and vendor financing)
- Merck (revenue recognition)
- MicroStrategy (backdating of sales contracts)
- Network Associates (revenue and expense recognition)
- PNC Financial Services (accounting for the transfer of loans)
- Qwest (revenue inflation)
- Reliance Resources (revenue inflation through round-trip energy trades)
- Rite Aid (inflation of earnings)
- Tyco International (improper use of "cookie jar" reserves and acquisition accounting)
- Vivendi Universal (withholding information about liquidity troubles)
- WorldCom (revenue and expense recognition)
- Xerox (revenue and earnings inflation)

These cases and their points of controversy are summarized in Bloomenthal (2002), Appendices E-1 and E-2.

EXHIBIT 2 | General Electric's (GE) Code of Conduct

- Obey the applicable laws and regulations governing our business conduct worldwide.
- Be honest, fair, and trustworthy in all your GE activities and relationships.
- Avoid all conflicts of interest between work and personal affairs.
- Foster an atmosphere in which fair employment practices extend to every member of the diverse GE community.
- Strive to create a safe workplace and to protect the environment.
- Through leadership at all levels, sustain a culture where ethical conduct is recognized, valued, and exemplified by all employees.

Source: General Electric Company, "Integrity: The Spirit and Letter of Our Commitment," February 2004, 5. A longer version of this resource is also available on the company's Web site at http://www.ge.com/files/usa/en/commitment/social/integrity/downloads/english.pdf.

EXHIBIT 3 | Excerpts from the CFA Institute's Code of Ethics and Standards of Professional Conduct: January 1, 2006

CFA Institute's Code of Ethics

- Act with integrity, competence, diligence, respect, and in an ethical manner with the public, clients, prospective clients, employers, employees, colleagues in the investment profession, and other participants in the global capital markets.
- Place the integrity of the investment profession and the interests of clients above their own personal interests.
- Use reasonable care and exercise independent professional judgment when conducting investment analysis, making investment recommendations, taking investment actions, and engaging in other professional activities.
- Practice and encourage others to practice in a professional and ethical manner that will reflect credit on themselves and the profession.
- Promote the integrity of, and uphold the rules governing, capital markets.
- Maintain and improve their professional competence and strive to maintain and improve the competence of other investment professionals.

CFA Institute's Standards of Professional Conduct (*excerpts that suggest the scope and detail of the complete standards*)

Members and candidates must:

- Understand and comply with all applicable laws, rules, and regulations . . .
- Use reasonable care and judgment to achieve and maintain independence and objectivity in their professional activities. Members and candidates must not offer, solicit, or accept any gift, benefit, compensation, or consideration that reasonably could be expected to compromise their own or another's independence and objectivity.
- Not knowingly make any misrepresentations relating to investment analysis, recommendations, actions, or other professional activities.
- Not engage in any professional conduct involving dishonesty, fraud, or deceit, or commit any act that reflects adversely on their professional reputation, integrity, or competence.
- Not act or cause others to act on the [material, nonpublic] information.
- Not engage in practices that distort prices or artificially inflate trading volume with the intent to mislead market participants.
- Have a duty of loyalty to their clients and must act with reasonable care and exercise prudent judgment. Members and candidates must act for the benefit of their clients and place their clients' interests before their employer's or their own interests. . . .
- Deal fairly and objectively with all clients. . . .
- Keep information about current, former, and prospective clients confidential. . . .
- Act for the benefit of their employer and not deprive their employer of the advantage of their skills and abilities, divulge confidential information, or otherwise cause harm to their employer.
- Not accept gifts, benefits, compensation, or consideration that competes with, or might reasonably be expected to create a conflict of interest with, their employer's interest. . . .
- Make reasonable efforts to detect and prevent violations of applicable laws, rules, regulations, and the Code and Standards by anyone subject to their supervision or authority.
- Disclose to clients and prospective clients the basic format and general principles of the investment processes used . . . Use reasonable judgment in identifying which factors are important to their investment analyses, recommendations, or actions and include those factors in communications with clients and prospective clients. . . . Distinguish between fact and opinion in the presentation of investment analysis and recommendations. . . .

Source: CFA Institute, *Code of Ethics and Standards of Professional Conduct* (Charlottesville, VA: CFA Institute), 2006, http://www.cfainstitute.org/cfacentre/pdf/English2006CodeandStandards.pdf.

Case Studies in Finance

Managing for Corporate Value Creation

PART 1

Setting Some Themes