FINANCE 311 – CASE STUDIES IN ETHICS

Instructions:
For each case please type your answers to the following questions.

1) What are the ethical issues with case?
2) What are possible alternatives?
3) What are the practical constraints?
4) What course of action should be taken and what are the ramifications of those actions?

Case 1: Metropolitan City Teachers' Retirement Fund Performance Appraisal

John Spence is a portfolio analyst for Metropolitan City Teachers' Retirement Fund (MCTRF), where he works under the newly hired investment director, Mary Trenkler. MCTRF is a defined benefits plan for all the municipal workers. Recently, Mary asked John to prepare a performance analysis of one of the pension fund's external growth stock portfolio managers, Bill Fredericks. Mary wants John to return with an analysis and recommendation either to retain Bill's firm or replace them with Growth Unlimited (GU), a firm which Mary has mentioned to john on two occasions as having "impressive results in growth stocks."

In the past, John has performed many such analyses by comparing risk and return performance over a three-year period and has to a large extent let the numbers determine his recommendations. This time, however, he is hesitant to do so. Although Bill's performance (Exhibit I) is well below GU's over the last three years, John does not want to see Bill's firm terminated. Bill has become a close personal friend to John, largely through their close working relationship. Bill's firm has given John help on various projects from time to time apart from growth stock investing and has provided John and other staff members the opportunity to attend educational seminars sponsored by his firm at no cost to MCTRF.

As an aside, John has calculated that Bill's performance is nearly equal to that of GU's over a seven-year period and is actually slightly better in the latest quarter. Additionally, from an efficient markets perspective, he can easily make the argument that relying on historical results is a very suspect way of evaluating future performance. In making his analysis, John is weighing the fact that he and MCTRF have historically placed a great deal of emphasis on the prior three-year performance, against his commitment to Bill, who has helped John's professional development and made him look good in front of his boss, Mary's predecessor.

Exhibit I

Portfolio Returns, Net of Fees and Commissions

	Bill Fredericks	Growth Unlimited	Growth Stock Universe
Last quarter	11.2%	10.3%	9.9%
Most recent year	12.8%	18.1%	18.4%
Two years (annualized)	11.9%	15.2%	12.5%
Three years (annualized)	13.1%	16.7%	13.7%

Case 2: The Accidental Bank Robbery

Chris wasn't really pleased with his current assignment as a relief branch manager at Commerce Trust Bank, but it was a means to an end. Employed by the bank for almost two years as a branch management trainee, Chris desperately wanted to escape the training program and begin a career as branch manager. He had earned strong praise from his superiors throughout the training program, and Chris hoped this last phase of training would pass quickly and uneventfully.

As a relief manager, Chris took over all management functions in various Commerce Trust retail branches whenever the regular office managers were called out of town for more than one day. The relief manager's position was particularly challenging, because Chris was called upon regularly to make quick decisions regarding check cashing, small loan approval, and employee supervision when he knew few of the regular branch customers and little about the daily office routines. For assistance, Chris often relied on the judgment and experience of the senior tellers and customer service representatives within each office he managed.

One recent assignment was particularly difficult because Chris was called to work in a small suburban office staffed by relatively inexperienced branch employees. At the end of his first full day in the office, Chris was not surprised when one of the branch's young tellers, Carole Baker, reported to him that her drive-in teller window was $900 short. While Chris was accustomed to out-of-balance teller windows, Carole was not. She had just completed teller school the week before Chris's arrival at the branch, and as a probationary employee, she knew that an unresolved $900 shortage would lead to the termination of her employment with the bank. When Carole approached Chris for help, she was in a state of panic

Given his experience in retail banking, Chris reassured Carole that he would locate the $900 shortage from the transactions ledger maintained by Carole's computerized teller terminal. Sure enough, after reviewing Carole's ledger entries for only a few minutes, Chris spotted the error. Carole had received a check for $100 from one of the bank's regular depositors, incorrectly entered it into the computer for $1,000, and paid out $900 more in cash than the amount shown on the check.

Both Carole and Chris were relieved to locate the error, and even more relieved that one of the branch's best deposit customers was the unexpected beneficiary of Carole's error. Surely the customer pulled away from the drive-in window without realizing the mistake. When Chris phoned the customer to explain the bank's error, however, he was shocked when the customer reported receiving only $100 from Carole's window. Even when Chris mentioned that Carole would lose her job if the error could not be resolved, the customer steadfastly maintained that Carole had only paid $100 in exchange for the $100 check.

Hanging up the phone, Chris turned toward Carole, who was now in tears. In order to reconcile her window, Chris would have to report the $900 error on Carole's shortage report. While the source of the mistake was clear to everyone at the branch, the loss appeared unrecoverable. When Chris reported the shortage to the bank's personnel department, as he was required to do by the bank's branch operations policy, Carole would be fired. Wasn't there something he could do, Carole sobbed, to balance her window without reporting the $900 loss? What should Chris do now?

It occurred to him that since the customer who took the money maintained some accounts with the bank, he could debit one of the customer's accounts for the $900. Alternatively, he could place the $900 loss in a temporary suspense account to balance Carole's window and resolve the issue at a later date. Chris was unsure whether to take one of these options or perhaps do something else.

Case 3: The Curious Loan Approval

As a commercial loan officer-trainee at Farmwood National Bank, Adam's future looked very bright. He had recently completed a series of credit analysis exams, earning the highest score in his training group and capturing the attention of the bank's senior commercial loan officers. In the second phase of his training program, Adam was promoted to a financial analyst's position and assigned to work for Mary Ryan, one of the bank's most productive commercial loan officers. Like Adam, Mary had earned the highest score on the analysis exams among her training group five years ago, and she and Adam quickly became a team to be reckoned with inside the bank's corporate banking division.

In the first few months of his new assignment, Adam quickly grew to admire his new boss. In most cases, when he evaluated the creditworthiness of a new customer for Mary, she readily agreed with his analysis and praised his attention to detail. However, one recent loan application left Adam totally confused. Evaluating a request from Mitchell Foods, Inc., for a $5 million short-term loan to finance inventory expansion, Adam noted that the firm was dangerously overleveraged. Mitchell Foods represented a retail grocery chain with 35 stores located in the greater metropolitan area served by Farmwood National, and the firm was financing its retail outlets with operating leases. Unlike financial leases, operating leases only appear in the notes accompanying the firm's financial statements, and Mitchell Foods'current balance sheet gave the appearance of far less leverage than the firm actually carried.

Adam promptly noted this fact in a memorandum of concern that he forwarded to Mary for inclusion in the Mitchell Foods credit file. Much to his surprise, Mary discounted the problem and told Adam to destroy the memo. After the bank's senior credit committee approved the Mitchell Foods loan request, Mary defended her position by telling Adam that the issue of operating lease leverage never surfaced during the credit committee meeting.

In spite of Mary's reassurances, Adam knew from his days in credit school that Mitchell Foods' operating lease liability was handled improperly. While pondering this problem over coffee in the employee cafeteria, Adam overheard Mary talking excitedly among a group of young commercial lenders. It seems she had just received word that her personal mortgage loan application at Bay Street Savings and Loan had been approved, and the terms of this loan were most attractive. The savings and loan willingly waived its normal down payment requirement and gave Mary 100 percent, fixed-rate financing of 25 years at 2 percent below the going rate of interest on fixed-rate mortgage loans.

Given his recent credit analysis, Adam recalled that the president of Mitchell Foods was also Chairman of the Board at Bay Street Savings. He began to wonder whether Mary's actions as a commercial loan officer had been compromised by her personal financial affairs, or whether he was simply thinking too much. After all, Mary was an outstanding commercial loan officer, and she was his mentor. What should Adam do next?

Case 4: A Shortfall at Ajax Inc.

If it weren't for its inability to obtain enough of Part P6729, a critical component in its newest and fastest selling product, Ajax Inc. would have been well on its way to financial success. But the delayed delivery of that part significantly increased the new firm's work in process. That, in turn, increased the demand for working capital as the firm stockpiled unfinished product in anticipation of delivery of Part P6729. In addition to its cash reserves of $616,000, Ajax needs $300,000 for the next few months to finance its temporary increase in working capital.

Joe Brown, a financial planner at Ajax, has been asked to suggest how to temporarily obtain the additional funds. In order to look as good as it can to the financial community, Ajax wants to make its financial statement be as attractive as possible. For this reason, Ajax would prefer to avoid borrowing from its banks or other financial institutions, or collateralizing any of its assets.

Joe is considering slowing the payment of Ajax's accounts payable. While the firm takes full advantage of its trade credit, it does carefully observe its trade credit terms. Joe maintains that by quietly delaying the payment of its bills by four additional days on the average, Ajax can obtain the use of an additional $300,000. He feels the firm will be able to do this for at lease a couple of months before suppliers begin to complain. By then, the firm will no longer
need the additional funds.

Joe discussed his proposal with some of his colleagues. Some wondered if the firm's suppliers would go along with the plan. Others doubted extending payment by only four days would raise that much money. But Edward Smith, a colleague whose opinions Joe respects, questions whether the firm should even be considering the proposal. He was not concerned about whether the plan is practical, feasible, or do-able. Rather, he felt it was not the ethical thing for the firm to do.

These discussions have left Joe wondering what he should recommend.