

**FINANCIAL TRANSACTION AND FIDUCIARY OBLIGATION: ETHICS,
ECONOMICS OR COMMINGLED COMMITMENT?**

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Abstract

Financial transactions and fiduciary obligations are simply intertwined. Fiduciaries are subject to the principle of fidelity. It appears, at times at least, public trust in fiduciary commitments is declining as a result of fiduciaries' selective reporting of financial events and the existence of conflicts when fiduciaries have selfish motives: motives being not always to maximize the trusting party's value. It is the *agency problem*. This work attempts to enunciate that commitments and fiduciary obligations emanating from initial financial transactions are not to be violated or ignored as a matter of policy or practice. The questions that arise are: Should a fiduciary be obliged to guarantee a certain outcome for the counter-party, and should a fiduciary be held accountable to a certain type of outcome? We examine what the guidelines are or should be put in place. Initially, under the garb of some socio-religions edicts-cum-dicta, and then under the well-known economic analytics, we make our points and move the view to the forefront.

Key Words: Financial contracts, Fiduciary obligation, Agency problem, Stewardship, Fidelity

JEL Classification: K22, M14, Z12

1. Introduction

Governance encompassing ethical issues that entail a display of meaningful loyalty in all forms of political and corporate conducts has been a subject of intense debate over many years, and over the past decade, in particular, since Enron, WorldCom, Pharmalat, OneTel, Inforsys, Dubai World and other financial disasters. Performing in the professionally responsible and loyal fashion with respect to other people's resources or firm's commitment of funds ought to characterize the conduct of investment managers and or fiduciary agents.

Technically, it is the issue of profit creation vis-a-vi shareholders', that is, investors' wealth build-up. Often, however, investors are significantly deprived of the fruits their investment funds spawn. Stone notes (1934), "...when the history of the financial era which has just drawn to a close comes to be written, most of its mistakes and its major faults will be ascribed to the failure to observe the fiduciary principle, the precept as old as holy writ, that - 'a man cannot serve two masters'." More than a century ago, equity gave a hospitable reception to that principle and the common law was not slow to follow in giving it recognition. No thinking man can believe that an economy built upon a business foundation can permanently endure without some loyalty to that principle. Regrettably, over the past few decades, fiduciary obligation became a judicial feat. In essence, less time and thought have been afforded to the concept of loyalty or fiduciary obligation, which is often associated with trust and trust-like relationships in which conflicts of interest and duty tend to arise (Flannigan, 1989).

Consistent with these views, DeMott (1988) contends that it may very well be the lack of discussions about what fiduciary entails that have created the current investigations into several improprieties that relate public's lack of faith in the reporting practices of corporations and the functioning of capital markets. Any breach of public trust amongst stakeholders requires one to revisit the moral and ethical obligations which include accountability, honesty, and transparency of each stakeholder in a trust relationship. Should governments and corporations wish to be virtuous and free, the obligations of moral leadership associated with the vocation can in no way be relinquished.

There is a long list of studies that relate religious and moral teachings on fiduciary obligation in government and business management. Islamic scholars have undertaken a thorough examination of relevant verses from the *Holy Qur'an* and the *Sunnah*: Ariff and Iqbal (2011). They have established the basic principles that govern the rights and obligations of participants in the financial transactions. A dishonest dealing by a fiduciary is presented in the parable of the dishonest steward in the Holy Bible (Luke, Chapter 16) where the unjust steward was accused by his master for squandering the master's wealth. While this parable is cited many a times in Christian communities, no evidence exists whether this is widespread in current business dealings. It would suffice to say that the frequency with which the media are reporting issues relating to fraudulent conduct, poor stewardship and errors of omission and commission of

deceptions is increasing at an exponential rate. Inherent and systemic corruptions in governments have also been witnessed more recently. Consequently, the causes of the catastrophic collapse of governments and corporations require deeper meaning and understanding of fiduciary obligation.

From an Islamic perspective, Beekun and Badawi (2005) argue that the link between Islam and business management has been sparse. Trust and benevolence are variables that are factored into an Islamic business model together with justice and balance. In Islam there are two primary sources, namely the *Holy Qur'an* and the *Sunnah* or *Hadith*, both of which recommend unequivocally what fiduciary obligation is. Essentially, the primary sources have implications for both individual and collective economic conducts. Moreover, economic as well as non-economic values, norms and codes are inscribed in the *Shari'ah Islamiyah*, commonly referred to as Islamic Law that draws extensively and exclusively from the two primary sources. According to Kamali (1989), the *Shari'ah* "refers to commands, prohibitions, guidance and the principles that God has addressed to mankind pertaining to their conduct in this world and [for] salvation in the next". The findings in the literature suggest that compliance to the revealed sources of knowledge (*Holy Qur'an* and *Sunnah*) and compliance to *Shari'ah* ought to be given the highest priority as sources of fiduciary power. Any potential for objectionable behavior ought to be thwarted by a conscious sense of internalized Islamic values.

The Western viewpoint DeMott (1988) in her seminal work contends that fiduciary obligation is one of the most elusive concepts in Anglo-American law. Notwithstanding the issues surrounding fiduciary obligation, an important clarification was made by Canada's Supreme Court by McLachlin (2003) where a majority of the Court agreed with McLachlin when she stated that fiduciary obligations were not obligations to guarantee a certain outcome for the vulnerable party, regardless of the fault. They do not hold the fiduciary to a certain type of outcome, exposing the fiduciary to liability whenever the vulnerable party is harmed by one of the fiduciary's employees. Rather, they hold the fiduciary to a certain type of conduct. This suggests that a fiduciary is not a guarantor of a certain outcome and a fiduciary does not breach his or her duties by simply failing to obtain the best result for the beneficiary.

Perhaps the widespread prevalence of these decisions in Western courts may have coincided with the actions of individual Muslims and therefore a sense of incongruence surrounding fiduciary obligation have crept into Islamic business conduct. The very nature of the terms

“fiduciary” and “obligation” renders them to a sense of discrepancy resulting in some divergence between Islamic philosophy and practice in economic life. The latter term, namely “obligation” is used in a variety of personal situations and embodies responsibility and accountability the extent of which is immeasurable. The former entails the use of the Latin word *fiducia* meaning trust and *fidere* meaning to trust. The issue that further exacerbates the definition is whether fiduciary obligation is intrinsic or extrinsic. In this regard the British Columbia Court of Appeal (1997) wrote of *fiduciary* as follows: every servant and every agent owes to his master or principal duties of good faith and fidelity (intrinsic). (S)he owes those duties because the law imports those duties as a contractual term or because the contract contains an express term to that effect (extrinsic) or because a court of equity would have imposed an obligation of good faith and fidelity as a matter of conscience (extrinsic and intrinsic). As a result the complex relationship existing in a servant-master and agent-principal scenario, a legal test for fiduciary duty is paramount. Servants and agents together with masters and principals have an intrinsic fiduciary obligation to safeguard their own interpersonal interests. The applicability of fiduciary and obligation in variety of contexts presents an opportunity to determine situation-specific fiduciary obligation. Resolving conflicts of obligations in fiduciary relationships requires an understanding of several subjective issues related to trust, faith and honesty.

From an Islamic perspective, Khan and Thaut (2007) in their seminal work on an Islamic perspective on fair trade, maintains that economic exchange in the form of trade and commerce played a vital role in the expansion of Islam and Islamic values of kinship, tradition and communal relationship. Scholars have identified Mecca as the birthplace of Islam and Mecca was a market and center for commerce. Khan and Thaut (2007) suggest that the early Muslims merchants were not only engaged in trade but they went to distant lands in connection with business. Moreover, they identify the Prophet Muhammad as a successful trader with integrity for which he was conferred the title ‘The Trustworthy’. This perhaps presented an opportunity to preach Islam and therefore a literature review suggests that fiduciary obligation in early Islam became intrinsic through the teaching of the Prophet Muhammad. The golden rule appears in the following statements attributed as revelation to Muhammad, “Woe to those . . . who, when they have to receive by measure from men, exact full measure, but when they have to give by measure or weight to men, give less than due”: *Qur’an (Surah 83: verse 1)*.

The rich value system of trust, honor and duty in Islam ought to be gradually passed on from one generation to another. Moreover, wealth should be circulated widely and not held or concentrated in the hands of a few. To encourage circulation of wealth, the *Shari'ah* encourages responsible trade. The *Shari'ah* also promotes commutative sales contracts and thereby the attainment of a monetized economy rather than barter. On the redistributive side, the *Shari'ah* also institutes *Zakat*, which is a religious tax based on wealth or income depending on the category of wealth held by Muslims. This is obligatory on all Muslims who possess wealth beyond a fixed minimum and hold it for at least one calendar year. The Islamic State collects it, in the absence of which individuals are obliged to pay it voluntarily on their own to the beneficiaries designated by the *Qur'an* (poor, indigent, travelers, bankrupt, *zakat* collectors), to liberate slaves or oppressed people and “in the way of God” especially in the month of fasting. The foundations of the social system of Islam rest on the belief that all human beings are equal and constitute one single fraternity. In this regard a fiduciary is expected to act thoughtfully and expediently. In the West courts impose a fiduciary obligation on the trusted party whereas in Islam one's conscience and one's submission to *Shari'ah* play a more meaningful role. Good conscience requires one to act at all times in the interest of the trusting party.

1.1 Identifying Trust and Obligation in Fiduciary Obligation

Since a fiduciary is one who is in a position of trust and him or her becoming the locus of control, it is the very essential characteristics of trust and control that present major problems in a fiduciary's obligations. Typically, a person or groups of interested persons get to trust one another for particular objectives or to accomplish certain tasks. A manifestation of trust becomes essential for commercial and economic activities to be sustained. Trust can be abused by the trusted parties when they do not act with care and diligence. The trusted party may intentionally divert value away from the party who has reposed the trust. A literature survey would identify at least three types of trust in corporate relationships. These include deterrence-based trust; knowledge-based trust and identification-based trust. In this regard Flannigan (1989) argues that only two types trust give rise to fiduciary obligations. He contends that in the first instance a person may trust another in an unconstrained and uninhibited personal way.

This form of trust is generally a result of feelings of intimacy or security brought about by the affection or concern for another and may also arise out of past trust experiences or conduct

created over time. At times this form of trust may come up instantly as a result of the office occupied by the trusted person or as a result of his or her knowledge, experience and expertise. Flannigan (1989) considers this as a 'deferential' kind of trust in that the trusting person will defer to the judgment of the trusted person. This deference may be total, or it may be only partial or situational and it is accompanied, in some cases, by elements of necessity, dependence or submission. In other cases there is no demonstrated vulnerability. However, what is paramount in relation to fiduciary obligation is that the trusted person is secured in the knowledge that his or her judgment is being relied on in the circumstances.

In the second form of trust identified by Flannigan (1989) there is typically no deference or vulnerability involved and an example given is the kind of trust that employers have in their agents and servants. In the Flannigan paradigm then employers expect their agents and servants to act faithfully although they do not have unreserved faith in them. They remain wary and, in extreme circumstances, even skeptical of them. Employers are 'vigilant' in the sense of remaining aware. They trust their agents and employees, but remain observant for signs that their trust is misplaced. The expectation underlying this kind of trust is that of fair dealing between competent and capable persons. Bogle (2009) cites Adam Smith who contented already in the 18th century that managers of other people's money rarely watch over it with the same anxious vigilance with which . . . they watch over their own . . . they very easily give themselves a dispensation, and Bogle (2009) concludes that management negligence prevails to a point of an almost complete disregard of their duty and responsibility to their principals. Following this trend of thought, one would argue that a dishonest steward could certainly be guilty of a clear breach of fiduciary duty by failing to administer the property solely in the interest of the beneficiary and continuing to serve his own interest.

1.2 Relations in Fiduciary Obligation

Fiduciary obligation is a necessary feature of an agency relationship. In this regard Flannigan (1989) posits that an understanding of the relationship and obligation that renders "the overall legal regime in which the interests of the various parties are accommodated or balanced". When someone has undertaken to act for and on behalf of another in a particular matter, this gives rise to a relationship of trust and confidence. Some fiduciary relations are more intense than others. The relationships could include, among others, beneficiaries and trustees; wards and

guardians; principals and agents; clients and lawyers; administrators of estates and executors; and next of kin and legatees.

The board of directors and the various officers are in a fiduciary relationship to the corporation and to the shareholders. Moreover, each partner in a partnership is in a fiduciary relationship to the other partners. The partner has the duty and power to consider and take care of the interests of the other partners, too. Following the same trend of thought, Scott (1949) writing in the *California Law Review* contends that the greater the independent authority to be exercised by the fiduciary, the greater the scope of his fiduciary duty. “A trustee is under a stricter duty of loyalty than is an agent upon whom limited authority is conferred or a corporate director who can act only as a member of the board of directors or a promoter acting for investors in a new corporation.”

1.3 From Agency Theory to Stewardship Theory

Schoorman, Mayer and Davis (2007) identify trust as an important aspect of a business relationship. Risk is at the core of business undertakings, and therefore it would not be surprising to conclude that trust would lead to risk taking in business relationships. The idea that “willingness to take risk” is embedded in trust. It is the view expounded by Sitkin and George (2005). This, however, spawns the scope for opportunistic and self-serving conduct of agents which presents challenges in a fiduciary relationship. As a result, the notion that an agent may not act in accordance with the interest of the principal, commonly referred to as agency conflict, and may subject the principal to several agency costs. These costs according to Flannigan (1989) are not created solely by those in the legal class of agents but other intermediaries and co-participants in ventures, too.

The function of the fiduciary obligation within this context would be to discourage any conduct that results in such intermediary or agency costs. Jensen and Meckling (1976), in their classic work on the theory of the firm, managerial behavior, agency costs and ownership structure, identify corporate managers as agents who are engaged to maximize the returns to principals, namely the shareholders. They assert that as agents do not own the corporation’s resources, they may commit certain ‘moral hazards’ merely to enhance their own personal wealth at the cost of their principals when they contract with executives to manage their firms for them.

In this regard Davis, Schoorman and Donaldson (1997) contention that the agency theory provides a useful way of explaining relationships where the parties' interests are at odds and can be brought more into alignment through proper monitoring and a well-planned compensation system stands valid. However, a more comprehensive theory such as the stewardship theory needs to be considered for further knowledge and understanding on the issue.

A distinguishing feature of the two different theories namely, agency theory from stewardship theory is the use of trust *versus* control systems to manage risk. The stewardship theory defines human behavior conduct beyond economic perspectives of perquisites. The literature dealing with stewardship is somewhat limited. On the surface, stewardship seems to be a simple concept, but the associated obligations are difficult to actualize. Stakeholders are held accountable for their decisions that ought to lead to sustainable institutions and overall care of the various capitals entrusted to them. These include resources in the form of human capital, financial capital, natural resources, social capital and cultural capital. As Davis, Schoorman and Donaldson (1997) see it, the stewardship theory has its roots in psychology and sociology; it examines situations in which executives as stewards are motivated to act in the best interests of their principals where the model of man is based on a steward whose conduct is ordered such that pro-organizational, collectivistic behaviors have higher utility than individualistic, self-serving behaviors. This is reflective essentially of general partner *vis-à-vis* limited partner in partnership model of business venture.

It is argued then that given a choice between self-serving behavior and pro-organizational behavior, “a steward's behavior will not depart from the interests of his or her organization”. “A steward will not substitute or trade self-serving behaviors for cooperative behaviors. Thus, even where the interests of the steward and the principal are not aligned, the steward places higher value on cooperation than defection because the steward perceives greater utility in cooperative behavior and behaves accordingly, his or her behavior can be considered rational”. If one considers the principal's point of view that a fiduciary needs to protect and provide guidance and support to an organization together with the singular hope of ensuring the resources are handed over to new stewards in a condition that is as good or better, then the stewardship theory seems superior. Religious teachings manifest stewardship theory in many forms. One can see this in the parable of the talents in the Bible (Luke, Chapter 19) “Well done, good and faithful slave!

You have been faithful in a few things. I will put you in charge of many things. Enter into the joy of your master.”

From an Islamic viewpoint, Khalifa is the Arabic term for stewardship or fiduciary defined as a person or persons who hold(s) assets in trust for a beneficiary. Khalifa relates to the nature of a legal trust (holding of something in trust for another). This entails a fiduciary contract in a fiduciary capacity with fiducial power. It is illegal for a fiduciary to misappropriate resources for personal gain. One of the well known *Hadith* of Prophet Muhammad “*Kullu kum ra’in wa’ kullu ra’in mas’ool an rai’yatay-hi...*” meaning that “*Every one of you is a caretaker, and every caretaker is responsible for what he is caretaker of*” defines the nature of stewardship in Islam. It signifies and requires that fiduciary obligations must be honored always.

2. Business, Ethics and Profits

In section 1, we have discussed and adumbrated the moralistic approach, rooted in religious edicts and principles, that fiduciary obligations must be met because of the overarching importance of trusts and commitments underlying the financial transactions or any commitments. We have noted that fraudulent behavior often emerges and commitments are not met. Here, within the framework of economic principles, we bring out the same issue and examine the root or underlying calculation of the violation of commitments. In the area of economics, ethics appears more in the name of reality and corporate governance than in the name of didactic dictums. In a piece (2010), Ghosh, Ghosh and Zaher have raised the issue: business, ethics, and profits: are they compatible under corporate governance in our global economy? They have noted and observed the following:

“...the traditional belief that profits and ethics are at odds with each other in the world of business. Corporate governance appears to be a hindrance or a drag on profit maximization. (They) show that moral codes, public interest and social values pose no threat to profit maximization of any firm. It is demonstrated with the illustration of transfer pricing and public goods-based economy that profits and ethics are quite compatible within the strait jacket of societal norms and corporate goals.”

In the Section I, we have indicated that agents who are the custodians of people funds may engage in practices that are not consistent the investors’ interest. To make the point louder we bring out a sketchy income statement of a firm as follows, and then point to the reality that

counter-productive conduct of fiduciary agents may go against their own snatch-it-all, snatch-it-away short-term goal of maximizing fiduciary interest:

Table 1: Income statement of XYZ corporation

1. Gross revenue ($R = P.X$)	\$100,000,000
2. <i>minus</i> fixed costs, including agents' salary and bonus (F)	20,000,000
3. <i>minus</i> variable costs, e.g., wages, utilities, etc. (V)	25,000,000
4. Earnings before interest and taxes (EBIT)	55,000,000
5. <i>minus</i> interest expenses, bondholders, banks, etc. (I)	15,000,000
6. Taxable income or profit before taxes (PBT)	40,000,000
7. <i>minus</i> taxes @25% (T)	10,000,000
8. Net income (NY)	30,000,000
9. <i>minus</i> dividends to preferred stock holders (PD)	10,000,000
10. Earnings available to common stock holders (EAC)	20,000,000

EAC (in line 10) is the shareholders net wealth or net profit. If the agents of XYZ Corporation increase their emolument to make line 2 to be more (say, \$30,000,000), *ceteres paribus*, line 10 drops to \$12,500,000. Fiduciary (that is, the top management of the firm or any individual trustee) can violate the embedded trust and rob the investor(s). Note:

$$\frac{EAC}{N} = EPS \equiv DPS + REPS. \text{ Here } N \text{ is the number of shares outstanding, } EPS, DPS, \text{ and}$$

interest on loan are well-known and well-accepted fact of economic calculus that the discounted

value of DPS , that is, $\sum_{t=1}^T \frac{DPS_t}{(1+r)^t}$ measures the value of a share of the investor (where DPS_t is

the dividend per share at time 1 and the time horizon for dividend flows is T periods from now.

It is evident now that if EAC is reduced by fiduciary by his/her grab-all or grab-most policy in line 2, EPS drops and the value of the share drops, fiduciary's compensation (fixed salary and bonus) has to go down, and in extreme situations the fiduciary can be given the pink slip. Any prudent and far-sighted manager must therefore be induced to keep the obligation intact to the

extent possible for the reality of economic dynamics, even if ethics and moral pressure are not persuasive enough.

Note obligation is a constraint. Economics is the science of constrained optimization (that is, either maximization or minimization). Wealth maximization or profit maximization is never unconstrained. In the world of business we encounter two facets of economic reality simultaneously in general equilibrium: profit maximization (by producers-cum-sellers) and utility maximization (by consumers). When business ownership is construed within the straitjacket of corporate structure, profit maximization turns into what we have already labeled as wealth maximization of shareholders.

Since corporations are managed by agents such as the Board of directors, CEOs and CFOs and so on, we know, as already noted, the agency problem, – the conflict between agents and owners of firms (that is, shareholders) rears its head, and this creates the failure by the agents to keep their commitment or obligation as self-interest dominates in their operations and calculations. Corporate governance has come into existence to reduce or eliminate this conflict of interest. The existing literature waxes eloquently on various facets on this and related aspects and concerns. Following the classic work of Jensen, and Meckling (1976), followed by Fama (1980), and a series of papers (e.g., Fama and Jensen (1983), Demsetz and Lehn (1985), Shleifer and Vishny (1986), Morck, Shleifer and Vishny (1988), Jensen and Murphy (1990), Agrawal and Knoeber (1996), Han and Suk (1998), Bryan, Hwang and Lilien (2000), to wit a few) has examined how business, ethics, and profits can be compatible under the rules of corporate governance.

It should be noted, however, that most people think business firms and contractual deals are driven solely by profit motives. Baumol (1959, 1962, 1970), Williamson (1964), Hicks [1954], and others, however, have raised questions as to the adequacy, tenability and unqualified validity of that view, particularly within the framework of long-term maximization principle. To Frank Knight (1888), "... perhaps no term or concept in economic discussion is used with a more bewildering variety of well-established meanings than profits". Building further on Hawley's view, Knight considers profits as rewards for taking risks and facing uncertainty, notion alluded independently in Section 1.

No matter how we construe profits, we recognize that business and profits are intimately linked and financial transactions and fiduciary obligations are intertwined. The issue at hand is: what has ethics to do with either business or profits? It is normally perceived that ethics is a set of moral codes that usually stands to inhibit wanton pursuit of selfish interest, and thus it puts a brake on the profits a corporation seeks to make and enlarge (and agents often try to divert them away from equity holders). Very aptly, profits and ethics in this view are at odds with each other. The governments - federal, state and local - in most societies watch over the business practices of corporations and other profit-seeking entities in an effort to resolve any conflict between the two ends. The Anti-Trust division of the U.S. Justice Department regularly checks out and forestalls the creation of unwanted monopoly power in the United States. The Securities and Exchange Commission (SEC) monitors trading and brokerage houses, and makes insider trading outright illegal. The Internal Revenue Service (IRS) makes sure that every business organization fulfills its tax liabilities, provides the correct compensation to its employees and social security benefits, and so on. Tax evasion is a felony punishable by laws in any land. In this view, it appears that ethics is antithetic to a positive business climate. Empirical evidence can be cited to make this point clear in real life. In a more comprehensive work we can document claims made that ethics and profit are mutually exclusive.

Here, in this paper, we show that profits and ethics are not necessarily at loggerheads with each other. Fiduciaries should realize that and should avoid non-fulfillment of fiduciary obligation. Indeed, efforts to link ethics as a management tool to increase productivity and ultimately profits have been verified by Burke and Black (1990). It is possible to identify many claims that "...when we do what we believe is proper [i.e. ethical], the company gains." Some practitioners who have strongly incorporated social responsibility have noted that their gross yields are comparable to anyone in money market funds. While, Anita Roddick of The Body Show, a company committed to ethical decision-making, stresses that "for more than 10 of 15 years that it has been in business, its sales have grown an average of 50 percent a year. William Ouchi (1981) sums up that "...profits are the reward to the firm as it continues to provide true value to customers, to help its employees to grow, and to behave responsibly as a corporate citizen."

On the other hand, it may appear at times that relaxation of ethical standards may enhance profitability, whereas rigorous enforcement of the existing ethical standards and/or introduction of additional ones will attenuate profits as well as the growth of business in our societies. Our conclusion is that such a perception is faulty, and often misleading and deceptive. It may be contended, and a point is always made by the opponents of ethics in business, that *laissez faire* means the absence of any impediment, and any ethical codes are nothing but impairment of business.

2.1 What is the Goal of Business: Social Responsibility and/or Profitability?

Milton Friedman (1970) article in the *New York Times Magazine*, “The Social Responsibility of Business is to Increase its profits,” begins the debate which continues today. Labeling the concept and any application of social responsibility as a “fundamentally subversive doctrine,” Friedman has emphasized that the doctrine “does harm the foundations of a free society.” Further, he stresses that the only responsibility of business is “to use its resources and engage in activities designed to increase profits.” Arguments immediately from many scholars, Stone (1975), Bell (1973), and Goodpaster, and Matthews (1982) counter the Milton doctrine.

Almost two decades later, Grant (1991), in “Friedman Fallacies” calls Friedman’s argument ‘erroneous’ because it rests on assumptions of an “apolitical political base, altruistic agents of a selfishness and good derived from greed .” O’Neil and Pienta (1994) argue that “profitability is a legitimate end of a business, but must be moderated by ethical considerations.” The authors note that schools of business are one place where selfishness is considered a virtue legitimized by the profit maximization model. Few have tested the ethics/profit proposition and where empirical evidence does exist when they are conflicting. Owen and Scherer (1993) cite almost an equal number of studies which supports as it reject a positive relationship between corporate social responsibility and firm financial performance. The major findings note that actions related to environmental pollution, corporate philanthropy and information disclosure have the greatest effect on market share. The evidence is modest, but the argument for including ethical decision making in firms as a responsibility is overwhelming. One of the clearest statements of the multiple responsibilities, beyond making a profit, of business is by Angelidis and Ibrahim (1991) who state that the diverse expectations of managers include “maximizing profits for owners and shareholders and for operating within the legal framework. They are also

expected to support their employees' quality of work life, to demonstrate their concern for the communities within which their business operates, to minimize the impact of various hazards on the global environment, and to engage in purely social or philanthropic endeavors.”

2.2 A Multinational Corporation (MNC) and its Potential Behavior

It is often observed or otherwise one can easily visualize that if a multinational corporation is not prohibited from being engaged in transfer pricing, it will undoubtedly enter into it because of its gains in way of tax savings can be made and the resultant increase in corporate income in the consolidated income statements of the company can be realized. Scholar such as Fowler (1978), Eden (1998), and many others have examined transfer pricings and corporate income extensively. It is and can be contended that if capital is raised from all markets where the MNC operates, it can be shown that increase in consolidated income of the corporation *via* transfer pricing is not necessarily beneficial to the enterprise. To make the point clear, examine the following hypothetical income statements of the corporations and its subsidiaries or affiliates. Let A and B be two subsidiaries (or affiliates) of the company, and C be the parent (combined) company.

Table 2: Income statement

	A	B	C
Sales (R)	\$100,000	\$200,000	\$200,000
COGS (C)	(60,000)	(100,000)	(60,000)
EBIT	40,000	100,000	140,000
Interest (I)	(4,000)	(4,000)	(8,000)
Income (NI)	21,600	57,600	79,200

Table 3: Modified income statement

	A	B	C
Sales (R)	\$150,000	\$200,000	\$200,000
COGS (C)	(60,000)	(150,000)	(60,000)
EBIT	90,000	50,000	140,000
Interest (I)	(4,000)	(4,000)	(8,000)
Income (NI)	51,600	27,600	79,200

The first situation is a depiction of the corporation's low mark-up policy, and the modified statement describes the high mark-up policy under a constant marginal corporate income tax rate of the 40 percent. Manipulative behavior, - doctoring the subsidiary-level mark up and transfer pricing do neither change the total liability nor the total corporate income. But, if the tax rates are different for *A* and *B*, then the transfer pricing underlying this statement structure yields a different picture. Let us assume that *A* faces 25 percent tax rate and *B* faces the same old 40 percent rate of taxation. Under this modification, the income statements presented earlier appear as follows:

Table 4: Income statement

	<i>A</i>	<i>B</i>	<i>C</i>
Sales (R)	\$100,000	\$200,000	\$200,000
COGS (C)	(60,000)	(100,000)	(60,000)
EBIT	40,000	100,000	140,000
Interest (I)	(4,000)	(4,000)	(8,000)
PBT	36,000	96,000	132,000
Taxes (T)	(9,400)	(38,400)	(47,400)
Income (NI)	27,000	57,600	84,600

Table 5: Modified income statement

	<i>A</i>	<i>B</i>	<i>C</i>
Sales (R*)	\$150,000	\$200,000	\$200,000
COGS (C)	(60,000)	(150,000)	(60,000)
EBIT	90,000	50,000	140,000
Interest (I)	(4,000)	(4,000)	(8,000)
PBT	86,000	46,000	132,000
Taxes (T)	(21,500)	(18,400)	(39,900)
Income (NI)	64,500	27,600	92,100

Here, transfer pricing in combination with high mark-up at *A* generates tax savings of \$7,500 (= \$47,400 - \$39,900), and thus increases the corporate earnings of \$7,500 (= \$92,100 - \$84,600). Because of this extra gain under differential tax structure, the corporation is seemingly induced to enter into unethical behavior of not pursuing the “arm’s length” transactions.

Let us go beyond the numerical framework and introduce a theoretical structure around those paradigms presented earlier. Let us use the following notations:

R_i = sales proceeds of company I ($i = A, B, C$);

C = costs of goods sold (COGS);

$EBIT$ = earnings before interest and taxes (= gross profits);

I = Interest expense or debt charge, assumed constant for both A and B;

PBT_i = profits before taxes of i (= taxable income);

T_i = corporate tax for i ;

NI_i = net income of i .

From definition, one can derive the following:

$$NI_A = (1 - T_A)\{R_A - C - I\} \quad (1)$$

$$NI_B = (1 - T_B)\{R_B - C - I\} \quad (2)$$

$$\text{and } NI_C = (1 - T_C)\{R_C - C - I\} \quad (3)$$

It is obvious that if $T_A = T_B = T$ (say, 40%), then transfer pricing markup differential is inconsequential. However, if $T_A < T_B = T$ (say 40%), the company will attempt to change the mark-up policy and engage in transfer pricing.

The question is: is the MNC really gaining by unethical practice in this case? The answer is not affirmative in clear terms. First, in corporate environment where reward of the agents are performance based, A and B are made to go through financial facelifts. A is made to look superior and B inferior, as the last line of Table 4 exhibits. This may indeed create uncomfortable positions in two subsidiaries and diminution of actual as well as potential incentives towards growth and stability. Intercompany enmity may do more damage than the potential gain unethically the company can generate in such data manipulation. The section 482 of the U.S. Internal Revenue Code prohibits this practice of transfer pricing.

The IRS regulations provide three ways and means to establish arm's length price: (i) comparable uncontrolled prices, (ii) cost plus, and (iii) resale prices. The OECD committee on Fiscal Affairs did make the same recommendation for European countries. Any attempt to get around these regulatory codes may be deliberately leaked because of the rivalry created through transfer pricing mechanism, and that may lead to disastrous consequences involving a much larger loss than the original profit created through contrivance. Secondly, distortion in the reallocation process will affect the capital market position for both A and B. B will have reduced earnings per share, and the net worth of shareholders will go down. A will have an opposite situation: earnings per share will be up, and net worth will rise. But loss at one end and gain at the other end do not give the clear picture for market participants as a whole. It simply raises the inter-subsidiary and inter-personal income redistribution, and the final result as to whether it is better or worse for the society is not ascertainable.

2.3 The Profit-Maximizing Behavior of a Firm

The traditional view that each firm optimizes the following maximand:

$$\pi = R(X(G)) - C(X(G)) \quad (4)$$

Here π , R , C , X , and G stand for profit level, sales revenue, cost for the firm, output level, and public good, respectively. Assuming "well, behaved" revenue and cost functions, one obtains that when the following conditions hold:

$$\partial\pi/\partial X = \partial R/\partial X - \partial C/\partial X = 0 \quad (5)$$

$$\partial^2\pi / \partial X^2 = \partial^2 R/\partial X^2 - \partial^2 C/\partial X^2 < 0 \quad (6)$$

profit is maximized. Under this exercise, G is ignored as a *ceteris paribus* condition. Before we bring this out, first let us point out the inadequacy of the results derived from (5) and (6). We all know that (5) brings out the equality of marginal revenue and marginal cost as the necessary condition for profit maximization, and (6) defining the sufficiency condition spells out that the rate of change of marginal revenue must be less than that of the marginal cost. Note here the Amoroso-Robinson result:

$$\text{marginal revenue} = \text{price} \times \left(1 - \frac{1}{\varepsilon}\right),$$

where ε is the price elasticity of demand. Since, it is a mere mathematical necessity that:

$$\text{marginal revenue} > 0 \text{ only when } \varepsilon > 1;$$

$$\text{marginal revenue} = 0 \text{ only when } \varepsilon = 1;$$

$$\text{marginal revenue} < 0 \text{ only when } \varepsilon < 1,$$

one can immediately conclude that the producers of goods and services with inelastic demand (that is, with $\varepsilon < 1$) cannot reach a profit-maximizing situation when each additional output entails additional cost (signifying that marginal cost is positive). Baumol [5], Brown and Revankar [7], and Ghosh [15] have pointed out that profit-maximization alone cannot explain a firm's behavior; some other objective(s) may be necessary to obtain the optimum.

As already pointed out, G – the provision of public good – has been ignored thus far. With its introduction, (5) and (6) are modified as (5*) and (6*):

$$\partial\pi/\partial X = \{\partial R/\partial X - \partial C/\partial X\}(\partial X/\partial G) = 0 \quad (5^*)$$

and

$$\partial^2\pi/\partial X^2 = \{\partial^2 R/\partial X^2 - \partial^2 C/\partial X^2\}(\partial^2 X/\partial G^2) < 0 \quad (6^*)$$

Here we postulate that $G = f(X)$, $f'(X) > 0$, and hence, by Jacobi's Theorem, X is invertible, - that is, $X = f^{-1}(G) \equiv F(G)$, $F'(G) > 0$. We do not know, however, if $\partial^2 X/\partial G^2$ is greater than or equal to or less than 0, and hence (6*) is not necessarily satisfied for the firm unconditionally. If the firm chooses the sales level that it thinks is profit-maximizing may, in turn, may be profit-minimizing. If $\partial^2 X/\partial G^2 = 0$, it is a point of inflection, and if $\partial^2 X/\partial G^2 < 0$, the firm is in its most suboptimal profit situation. The traditional belief holds if and only if $\partial^2 X/\partial G^2 > 0$.

It is a narrow view to assume that social good is a free good, and the firm has nothing to relate to it. A public road is a public good, and if it is not there, as President Barack Obama of the United States remarked recently on his campaign trail, the firm has to incur additional cost to transport its outputs and inputs. Without proper adequate infrastructure, business can hardly survive, and much less to thrive on. Free-rider mind-set may give rise to the belief that ethics or regulation is inimical to business and profits. A well-ordered environment, protected by laws that promote the harmony between consumers and producers, and ethics that stands as the *terra firma* of the laws can sustain a society with customers and vendors enjoying optimum position, side by side.

Not too long ago, under the Clinton Administration the universal health care coverage, costs, and employer mandates had touched off a debate on the advisability of the plan and the survivability of small businesses. The Obama Administration has passed it into law. The point is often made that insurance premium on the employer will raise the costs, lower the profits to the vanishing point, causing hereupon the demise of business. One point is ignored in this logic is that worry-free and healthy worker is a more efficient worker, and efficient worker means a higher output per input. It is like the Harrod-neutral (labor-augmenting) technical progress, which essentially contributes to the growth of the corporation. Unless the efficiency elasticity of cost is estimated, it is futile to think even that insurance policy as being mandated is profit-reducing. Thus, reduction in profit owing to insurance premium on employer is not a valid argument, particularly in the long-run context. If employers are what Hicks (1954) calls “snatchers” (of short-term profits) and not “stickers” (for long-term profits), universal health care coverage may not win; but a more dynamic, long-range view of business, ethics and profits in an international economic structure in which most competing countries have medical guarantee for workers can justify the Clinton proposal and the Obama’s Affordable Health Care law.

2.4 Analytical Structure: Portfolio Manager Knows Investor’s Utility Function

Next, take a step forward and move into an analytical development of portfolio selection, revision and comparative statics. Following the works of Royama and Hamada (1967), Ghosh (1988), and Morishima (1993), who have done some of these exercises on the effects of parametric variations, we proceed by assuming that the current asset prices are normalized, and

each current price is then equal to 1; prices at the end of the period are expected to be p_1, p_2, \dots, p_n . It means that

$$1 + r_i = p_i \quad (7)$$

$$M = \sum_i p_i s_i$$

where p_i 's is the price of the i -th asset, which is a stochastic variable. The investor's expected values and variance co-variance terms are as follows:

$$E(p_i) = \mu_i, \text{ and } E(p_i - \mu_i)(p_j - \mu_j) = \sigma_{ij} \quad i, j = 1, 2, \dots, n.$$

$$\text{Let } \mu = E(M) = \sum_{i=1}^n \mu_i s_i, \text{ and } \sigma = \sum_{i=1}^n \sum_{j=1}^n \sigma_{ij} s_i s_j.$$

Assume that the investor maximizes his von Neumann-Morgenstern utility function:

$$U = U(\mu, \sigma)$$

subject to:

$$\sum_{i=1}^n \pi_i s_i = M_0, \text{ and so his maximand is the following Lagrangean:}$$

$$L = U(\mu, \sigma) + \lambda \left(\sum_{i=1}^n \pi_i s_i - M_0 \right) \quad (8)$$

where λ is the Lagrangean multiplier, and (8) is the expression of constrained maximization. Obviously, the first-order condition of the Lagrangean optimand results in the following expression:

$$U_{\mu} \mu_i + 2U_{\sigma} \sum \sigma_{ij} s_j = \lambda \pi_i \quad i = 1, 2, \dots, n. \quad (9)$$

Partial differentiation of (9) with respect to π_k yields the following:

$$\begin{bmatrix} 0 & \pi_i \\ \pi_j & m_{ji} \end{bmatrix} \begin{bmatrix} -\frac{\partial \lambda}{\partial \pi_k} \\ \frac{\partial s_j}{\partial \pi_k} \end{bmatrix} = \begin{bmatrix} -s_k \\ \lambda \delta_{jk} + m_j \end{bmatrix},$$

where

$$m_{ji} = U_{\mu\mu} \mu_j \mu_i + 2U_{\mu\sigma} \mu_j \sum_{\alpha} \sigma_{i\alpha} s_{\alpha} + 2U_{\sigma\mu} \mu_i \sum_{\alpha} \sigma_{j\alpha} \pi_{\alpha} + 2U_{\sigma\sigma} \sigma_{ji} + 4U_{\sigma\sigma} \left(\sum_{\alpha} \sigma_{j\alpha} \pi_{\alpha} \right) \left(\sum_{\alpha} \sigma_{i\alpha} \pi_{\alpha} \right) \text{ and}$$

$$d m_j = -(U_{\mu} \delta_{jk} + U_{\mu\mu} \mu_j s_k + 2U_{\sigma\mu} s_k \sum_{\alpha} \sigma_{j\alpha} s_{\alpha}) \frac{d\mu_k}{ds_k}, \delta_{jk} \text{ being the Kronecker delta.}$$

Now one can immediately deduce the following:

$$\frac{\partial s_r}{\partial \pi_k} = -s_k Z_r + \lambda Z_{kr} - \{U_{\mu} Z_{kr} + U_{\mu\mu} s_k \left(\sum_j \mu_j Z_{jr} \right) + 2U_{\sigma\mu} s_k \sum_j \left(\sum_{\alpha} \sigma_{j\alpha} s_{\alpha} \right) Z_{jr}\} \frac{d\mu_k}{d\pi_k} \quad (10)$$

Here Z_r and Z_{kr} are the ratios of cofactors of π_r and g_{kr} of the following determinant:

$$D \equiv \begin{vmatrix} 0 & \pi_1 & \cdot & \cdot & \cdot & \pi_n \\ \pi_1 & m_{11} & \cdot & \cdot & \cdot & m_{1n} \\ \cdot & \cdot & \cdot & \cdot & \cdot & \cdot \\ \cdot & \cdot & \cdot & \cdot & \cdot & \cdot \\ \cdot & \cdot & \cdot & \cdot & \cdot & \cdot \\ \pi_n & m_{n1} & \cdot & \cdot & \cdot & m_{nn} \end{vmatrix}$$

is the value of the determinant D. With a bit of algebraic manipulation now it easy to show that:

$$\frac{\partial s_r}{\partial \pi_k} = -s_k Z_r + \lambda Z_{kr} + U_{\sigma} \sum_j (B \delta_{jk} + \frac{\partial B}{\partial \mu} s_k \mu_j) \frac{d\mu_k}{d\pi_k} Z_{jr} \quad (11)$$

$$= -s_k Z_r + \lambda Z_{kr} + U_\sigma \sum_j \frac{\partial B_j}{\partial \mu_k} \frac{d\mu_k}{d\pi_k} Z_{jr} \quad (12)$$

where $B = -\frac{U_u}{U_\sigma}$ and $B_j = -\frac{U_u \mu_j}{U_\sigma}$. Here it is noted that $\sum_j \pi_j Z_{jr} = 0$.

Consider a more well-accepted utility function *à la* von Neumann-Morgenstern as follows:

$$U(M) = M - 1/2aM^2 \quad a > 0 \text{ and } M < 1/a \quad (13)$$

where $M = \sum_i (1 + p_i) s_i$. In this case then one can derive the following:

$$\frac{\partial s_r}{\partial \mu_k} = U_\sigma B Z_{kr} + U_\sigma \frac{\partial B}{\partial \mu} \mu_k \sum_j \mu_j Z_{jr} \quad (14)$$

These terms on the right-hand side are the standard Hicksian substitution and income effects. However, a change in μ_k affects the individual's demand through two channels: through the change in the relativity of μ_k to other μ_i 's, and through the change in the absolute level of $\mu = \sum_i \mu_i s_i$. In order to obtain the pure effect of μ_k on s_r , we introduce an imaginary change in μ so as to leave the individual on the same level of μ , as before. Such a compensated purely relative change in μ_k gives rise to a change in the s_i 's since, as (9) shows, the marginal rates of substitution between s_i 's depend on their relative expected real values.

This effect, which we may call the relative desire effect, is represented by the first term in (10). On the other hand, the change in the absolute level of μ , induced by the change in μ_k , affects the marginal rate of substitution between μ and σ . If $\frac{\partial B}{\partial \mu} > 0$, then the individual will be prepared to bear more risk than before when the absolute level of μ is raised. Such a change in the individual's risk aversion brings about a change in the holding of assets, which is represented by the second term of (10); it may be called the absolute desire effect.

Evidently, a similar analysis may be made if a change in a current price p_i induces a change in the variance of the real value of an asset or the covariance of the real values of some two assets. Optimum solution and comparative statics show that system works, and any irritations in the parameters such as manipulations by fiduciary will create chaos and instability, already noted through value creation of investors' initial funds.

3. Some Concluding Thoughts

A profit *versus* ethics is an old debate resurfacing time and time again. It is an issue that involves individual gain and social welfare. A vast and penetrating literature, following the path-breaking analysis of Arrow (1951), Collard's (1988) moral sentiments, Gapinski's (1988) right angle of non-profit theater, Garfield's (1999) profits and social responsibility mix, and so on have surfaced to highlight that profits and ethics are not inimical to each other. At times it may appear that social optimum is inconsistent with individual optimum choice, and at times these two ends seem to be mutually complementary. In case of conflict between these two objectives, it is an "impossibility" to find the optimum. A value judgment has to be made at this time, and one optimum has to be chosen in preference to the other.

If maximum good of the many is deemed better than the maximum good to one, maximum benefits to many must be the superior choice. Marris's (1964) economic theory of "managerial" capitalism, Svensson's (1989) fairness, the veil of ignorance, and social choice, Rawl's (1971) theory of justice, Schokkaet and Overlaet (1989) on moral intuition and economic models of distributive justice, Ginzberg and Solow's work (1974) should lead us to recognize that ethics and profits can and should co-exist on rational grounds. Social optimum is the choice in the society of many interests and individuals. The very acceptance of the government in our lives, and the "social contract" amongst the members of the society indicate that individual interest is subordinate to social welfare. A macroeconomic structure with its full interactive feedback mechanism and *mutatis mutandis* provisions should justify profits with ethics than without more strongly and cogently.

In formal way one may visualize the social welfare (W) as a function of agent's utility (U_1), business entities' utility (U_2), and then we have the following:

$$W = W(U_1, U_2) \tag{15}$$

where welfare function is quasi-concave. Try to maximize this welfare function, subject to the following “well behaved” transformation function:

$$T(U_1, U_2) = 0$$

So the problem is:

$$\text{Max } W = W(U_1, U_2) \tag{16}$$

$$\text{subject to } T(U_1, U_2) = 0 \tag{17}$$

This constrained maximization is simply a Lagrangean (L) optimization:

$$L = W(U_1, U_2) + \lambda\{T(U_1, U_2)\} \tag{18}$$

The canonical conditions on this optimization are as follows:

$$\partial L / \partial U_1 = W_1 + \lambda T_1 = 0 \tag{19}$$

$$\partial L / \partial U_2 = W_2 + \lambda T_2 = 0 \tag{20}$$

$$\partial L / \partial \lambda = T(U_1, U_2) \tag{21}$$

where $W_1 \equiv \partial W / \partial U_1 > 0$, $W_2 \equiv \partial W / \partial U_2 > 0$, $T_1 \equiv \partial T / \partial U_1 > 0$, $T_2 \equiv \partial T / \partial U_2 > 0$

From (19) and (20) we obtain:

$$W_1 / W_2 = T_1 / T_2 \tag{22}$$

Optimization yield the optimum social welfare: U_1^* and U_2^* define this optimum constellation.

If $U_1 = h(U_2)$, and $dU_1 / dU_2 = h'(U_2) \leq 0$ for $U_1 \leq \bar{U}_2$ and

$$dU_1/dU_2 = h'(U_2) > 0 \text{ for } U_1 > \bar{U}_2$$

The optimum is ascertainable. Hence, the impression that ethics is a profit-reducing instrument or a drag on business is a misconception. With ethics, a business enterprise operates and optimizes in the world rationally.

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