

Agency Theory as a Basis for Business Ethics

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Since the publication of Jensen and Meckling's seminal work in 1976, agency theory has become an important part of modern financial economics. Almost every introductory textbook in the field of corporate finance mentions agency theory and the existence of agency problems in its introductory chapter. It is commonly cited as one of the key areas in the development of modern financial thought.¹ Its principles have been extended provide explanations of merger activity and corporate restructuring, dividend policies, executive compensation, the composition of corporate boards, and capital structure, among other issues.

Agency theory defines the firm as a "nexus of contracts" between different resource suppliers. Two parties are central to agency theory; principals, who supply capital, and agents, who manage the day to day affairs of the firm. Since the interests of the agents are not necessarily those of the principal, the organization encounters agency costs. These costs consist the expenses of monitoring the behavior of agents, including budget restrictions, compensation practices (including stock options, bonuses, and other incentives), and the loss of profits due to operating rules and restrictions on management. They also include bonding costs of the agents, and the costs of sub-optimal decisions, defined as decisions that are made in the best interests of agents rather than principals.

¹ See, for example, Weston, J.Fred. "A (Relatively) Brief History of Finance Ideas" Financial Practice and Education (vol. 4, no.1.) Spring/Summer, 1994, pages 7-26; also Horrigan, James O. "The Ethics of the New Finance" Journal of Business Ethics (vol. 6, 1987), pages 97-110; also Jensen, Michael C. and Clifford Smith, "The Theory of Corporate Finance: A Historical Overview" The Modern Theory of Corporate Finance (McGraw-Hill, 1984), pages 2-20.

Agency theory assumes that self-interest motivates all parties, both principals and agents. Self-interest is defined as maximization of the utility of personal wealth. In making this assumption, Jensen and Meckling make no assertion about its morality. Rather, they simply claim that it is the best descriptor of human motivation. Nevertheless, this assertion generates a great deal of criticism in the literature of financial ethics.

There are also ethical implications in agency theory's definition of the firm as a "nexus of contracts." Jensen and Meckling state that this definition avoids the "personalization" of the firm as a whole, and places the responsibility for the firm's actions squarely on the shoulders of the agents who made the decisions. Critics of the definition feel it de-emphasizes the role of ethics in the development of corporate policies and promotes a "value-free" practice of financial decision making.

These beliefs to the contrary, there is no doubt in my mind that agency theory, when refocused to incorporate a broad definition of the firm's responsibilities, reflects the Biblical definition of morality and individual accountability for sin. Furthermore, it reflects the reality of God's relationship to mankind. For these reasons, I believe that agency theory offers tremendous potential to define and describe the true nature of the ethical dimensions of corporate behavior. This belief is not mine alone. Horrigan also believes in the potential of agency theory to justify ethical behavior. He says "...it (agency theory) bears watching in the future. If ethical dimensions are woven into it, it could make a very positive contribution to financial theory."²

² Horrigan, *op.cit.*, page 106.

In this paper, I define agency theory in such a way as to broaden the role(s) of the firm. This broader definition provides a more central role for ethics in corporate decisions. Section I of the paper reviews the criticisms of agency theory in the ethics literature. Postulates central to an ethical framework in finance are presented in Section II. In Section III, a revised view of agency theory is developed that incorporates the ethical framework presented in Section II. Relevant Christian teachings are discussed in Section IV, and Section V offers a Christian perspective on the basis of financial ethics.

I. Criticisms of Agency Theory

Agency theory remains somewhat controversial, particularly in the literature on financial ethics. For example, Horrigan claims that agency theory "...raises the ethical danger of creating a very contentious, litigious view of financial relationships, pitting agents against principals and principals against principals as perpetual adversaries."³ That the business world is a litigious place very few would deny. It has been so for some time – for longer, even, than Jensen and Meckling's article has been in print. Horrigan's view that the business world is an adversarial place is valid also, but this also hardly originated with agency theory. The world of business has competition at its very core. Competition exists not only among firms, but within firms, as employees compete for recognition, promotions, and salary increases. Agency theory acknowledges this world, but did not create it.

Dobson claims to be quoting Jensen and Meckling when he says that agency theory is based on the view that "...management's thirst for perquisites at the expense of

³ Horrigan, James O. "The Ethics of the New Finance" *Journal of Business Ethics* (vol. 6, 1987), page 106.

firm value is as inviolable as 'a world in which iron ore is a scarce commodity.'" ⁴ In fact, Dobson quotes this passage out of context. The passage merely refers to the pointlessness of comparing outcomes in a world with agency costs to outcomes where the presence of agency costs are denied, and saying that the latter is preferable. The full passage is below:

In conclusion, finding that agency costs are non-zero and concluding therefore that the agency relationship is non-optimal, wasteful, or inefficient is equivalent in every sense to comparing a world in which iron ore is a scarce commodity (and therefore costly) to a world in which it is freely available at zero resource cost, and concluding that the first world is 'non-optimal'..."⁵

Brennan objects to the "cynicism" and "harshness" of agency theory. He says that "...the prerequisite consumption model of Jensen and Meckling...rests on the assumption that a manager (agent) will steal what he does not own, so that it is probably more efficient to give it to him at the outset rather than put him to the trouble of stealing it."⁶ Brennan goes on to state that such agents should probably be replaced rather than tolerated within the organization. Brennan's recommendation about replacement is probably sound. It is (perhaps) made in tongue-in-cheek fashion, exaggerated (in Brennan's mind) for effect. However, it may be a denial of reality. For example, retailers traditionally have suffered more shoplifting losses from their employees than from the public. Those who steal are fired when caught, but it doesn't seem to slow the tide of losses.

⁴ Dobson, John. "Reconciling Financial Economics and Business Ethics" *Business and Professional Ethics Journal* (vol. 10, no.4) Winter, 1991, page 29-30.

⁵ Jensen and Meckling (1976), page 328.

⁶ Brennan, Michael J. "Incentives, Rationality, and Society" A talk given at the University of Maryland, April 2, 1993). Reprinted in Chew, Donald (ed.) The New Corporate Finance, New York, McGraw-Hill, (2nd edition, 1999), page 25-26.

It seems that many of the criticisms of agency theory rest on an implicit assumption of the perfectibility of man. The critics imply that if honesty and virtue were only given greater emphasis in our moral discussion, then people will behave in a more honest, virtuous manner. For example, Horrigan says that "Positive ideas inevitably become normative ideas when they are promulgated in decision oriented subjects, such as financial management."⁷ Dobson agrees, saying that "By *assuming* unbridled self-interest, financial economics *promotes* unbridled self-interest."⁸

However, evidence of the innate sinfulness of mankind is all around us. The Scriptures admonish Christians not to become too comfortable with their moral righteousness. The Apostle Paul, in the Book of Romans, compiles quotations from several Old Testament passages when he writes:

As it is written:

*There is no one righteous, not even one;
there is no one who understands,
no one who seeks God.
All have turned away,
they have together become worthless;
there is no one who does good,
not even one.
Their throats are open graves;
their tongues practice deceit.
The poison of vipers is on their lips.
Their mouths are full of cursing and bitterness.
Their feet are swift to shed blood.;
ruin and misery mark their ways,
and the way of peace they do not know.
There is no fear of God before their eyes.*⁹

Paul sums it up by saying "For all have sinned and fall short of the glory of God." ¹⁰

⁷ Horrigan, page 97.

⁸ Dobson, John, "Reconciling Financial Economics and Business Ethics" *Business and Professional Ethics Journal* (vol. 10, no. 4), Winter, 1991, page 30.

⁹ Romans 3:10-18 (NIV)

¹⁰ Romans 3:23 (NIV).

If any theory or set of ideas is going to help develop the moral sensibilities of managers, it must start with a view of the (business) world which is accurate in every respect. We cannot build a moral and virtuous world by assuming that immorality does not exist, nor by assuming that mankind is perfectible or is naturally evolving into such a state. The purposes of reform are best accomplished by starting with a realistic view of the world and of the nature of mankind. Agency theory does this, but receives criticism for it. Agency theory is grounded in the view that mankind is not perfect, nor naturally evolving in that direction.¹¹ In assuming self-interest as the primary motive of mankind, agency theory makes no claim that self-interest is morally preferable. In this sense, it recognizes our fallen state.

II. A Foundation for Ethics in Finance

In the secular literature on business ethics, there are at least two principles that form the foundation for ethical practice in finance. The first is a sense of responsibility for one's own actions, and the second is a view or definition of the corporation as a social institution rather than as property accompanied by inherent rights of ownership.

Christians add a third principle – the necessity for any true definition of ethics to be grounded in God's will, as found in the Scriptures and discovered with the assistance of the Holy Spirit.

The importance of accountability. Ang says that "Ethical behavior depends upon accountability. When managers are accountable for their actions, they are more likely to

¹¹ A good discussion of some of the implications of this assumption for the work of Christian business professors is found in a paper presented by Randy Lewis and George Joseph, presented at the 1999 CBFA meeting. (See list of References.)

behave ethically."¹² Goodpaster and Matthews list accountability as the first property of responsible agents. They state that "A morally responsible person is a person whose actions are reflective of a consideration for the impact of their actions on others."¹³

(Italics are those of the authors.)

The necessity of responsibility to ethical behavior is also reinforced in the Scriptures. God, in creating mankind in His own image, created us with the freedom to choose. With this freedom comes a responsibility, and He punishes us when we make choices that run counter to His will.¹⁴ These principles are among the most fundamental of all Scriptural teachings, and are a key to the Christian's understanding of the relationship between God and mankind. To deny the importance of individual responsibility in ethics is to deny the centrality of these teachings.

The corporation as a social institution. Viewing the corporation as a social institution, rather than as an extension of individual property rights, is also an important part of the ethical foundation of finance. There are two competing views of the firm. The first, called the social institution view, defines the corporation as a social institution sanctioned by the state (or by society) in order to achieve some social purpose. The firm's responsibility to society to achieve this purpose readily follows from this view. The second, competing view, is called the property rights view. In this view, the corporation is the private property of its stockholders, who may choose to do with the proceeds whatever they wish, subject to legal constraints. The property rights view defines the responsibilities of the corporation in a narrow sense (to the stockholders only,

¹² Ang, James S. "On Financial Ethics" Financial Management (vol. 22, no. 3) Autumn, 1993, page 36.

¹³ Goodpaster, Kenneth E. and John B. Matthews "Can A Corporation Have a Conscience?" Harvard Business Review (January-February, 1982), pages 134.

¹⁴ One of the best-known examples is the account of Adam and Eve in the Garden. See Genesis 3.

aside from whatever minimal legal requirements are imposed). Milton Friedman, a proponent of this view, has gone so far as to say that the very notion of a corporation's social responsibility is "pure rhetoric."¹⁵

Proponents of the property rights view state that, if individuals have a right to use their individual assets to form businesses, they certainly also have the right to combine assets for this purpose. One of the major legal affirmations of the property rights view came in the case *Dodge v. Ford Motor Company* (1919).¹⁶ The case was filed when Henry Ford declared he would not increase the company's dividends, choosing rather to lower product prices because his profits were already "high enough." Shareholders filed suit, and the Court found in their favor, declaring that "A business corporation is organized and carried on primarily for the profit of the stockholders."¹⁷

However, legal decisions have not always upheld this view. In *Munn v. Illinois*, a landmark decision studied by almost every Business Law student, the courts found that businesses, as a product of the state, are "...affected with a public interest..." and are therefore the proper subject of governmental regulation.¹⁸

Changes in the structure of ownership and management of modern corporations have also generated support for the social institution view. The shares of modern corporations are owned by numerous investors, many of whom have little involvement in corporate affairs. This fact, combined with the rise of a class of professional managers who exercise the actual control, has resulted in the separation of corporate ownership and corporate control.

¹⁵ Friedman, Milton. "The Social Responsibility of a Business is to Increase its Profits" *New York Times Magazine* (September 13, 1970), page 33.

¹⁶ *Dodge v Ford Motor Company* (Michigan State Supreme Court, 170 N.W., 1919).

¹⁷ *ibid.*, 668, 685 (1919).

In the property rights view, shareholders provide capital to the corporation and assume the risks. In return, they lay claim to the residual profits and to control of the organization through their voting rights. However, true ownership involves full control over property, as well as an assumption of responsibility. Most shareholders relinquish control of the corporation through the proxy process. Only in proxy battles, which are relatively rare, are shareholders given a true choice regarding the direction of the corporation. The financial responsibility and liability of stockholders is limited to the amount of their initial investment in the organization. Furthermore, modern finance theory teaches us that much of the operating risk of a corporation is non-systematic in nature. Rather than shoulder this risk, stockholders should simply diversify it away by holding stocks in portfolios. Through these developments, shareholders in the modern corporation are only another provider of resources (in this case, capital resources) with which the firm contracts.

Fama was among the first to recognize this issue and its impact on agency theory. Criticizing the owner-entrepreneur role as described in Jensen and Meckling, Fama said it "...fails to explain the modern corporation in which control of the firm is in the hands of managers who are more or less separate from the firm's security holders."¹⁹ He goes on to say;

*The ownership of capital should not be confused with the ownership of the firm. Each factor in a firm is owned by somebody. The firm is just the set of contracts covering the way inputs are joined to create outputs and the way receipts from outputs are shared among inputs. In this 'nexus of contracts' perspective, ownership of the firm is an irrelevant concept.*²⁰

¹⁸ *Munn v. Illinois*, 94 U.S. 113; 24 L. Ed. 77 (1876).

¹⁹ Fama, Eugene, "Agency Problems and the Theory of the Firm" *Journal of Political Economy* (vol. 88, no. 2, 1980).

²⁰ *ibid.*

With the separation of ownership and control, the role of trustee of the firm's assets is assumed by management. In this new position, managers face the question "To whom are they responsible?" Consistent with the social institution view of the corporation, managers have ceased being the exclusive servants of shareholders. They are looked upon as community leaders and have assumed responsibilities to society as a whole.

III. Agency Theory Revised

New roles for government and for the firm. To date, agency theory has defined the firm as the *principal*, and managers as the agents-trustees. This focus naturally highlights the responsibilities of agents *to* the corporation, while the responsibilities of the corporation to others have been ignored. If the role of the firm is redefined as an *agent* of society, which is represented by governmental bodies, the responsibilities *of* the corporation can be given a sharper focus.

Like firms, governments can be defined as a nexus of contracts, assembling resources for their own reasons. There is no principle of agency theory that would prohibit the firm being defined in the role of agent for government. In fact, Jensen and Meckling almost foresee this when they write "It is important to recognize that most organizations are simply *legal fictions*... This includes firms, non-profit institutions... co-operatives, some private clubs, and even governmental bodies."²¹ (Italics are those of the authors.)

²¹ *ibid.*

Government is certainly a legitimate party to consider as a principal. Government regulates the firm and the industry within which it competes. Government raises and lowers corporate taxes. Government plays a large role in shaping the broad social contract of society within which the firm operates. Government has a vast influence over economic conditions that impact corporate sales and profits. Government even grants the very charter that gives birth to the corporation and allows it to operate. In their seminal article on agency theory, Jensen and Meckling readily cite the centrality of the role played by the state in corporate affairs.

This view of the firm points up the important role which the legal system and the law play in social organizations, especially the organizations (sic) of economic activity. Statutory laws set bounds on the kinds of contracts into which individuals and organizations may enter without risking criminal prosecution. The police powers of the state are available and used to enforce performance of contracts or to enforce the collection of damages for non-performance. The courts adjudicate conflicts between contracting parties and establish precedents which form the body of common law. All of these governmental activities affect both the kinds of contracts executed and the extent to which contracting is relied upon. This in turn determines the usefulness, productivity, profitability and viability of various forms of organization. Moreover, new laws as well as court decisions often can and do change the rights of contracting parties ex post, and they can and do serve as a vehicle for redistribution of wealth.²²

Can government be trusted to act ethically in its role as principal? Toward what ends does government, as a nexus of contracts, use the resources it assembles? What are their goals? Idealists might list any number of lofty societal objectives, including generation of employment for citizens, provision of a better standard of living, furtherance of individual opportunity and self-development, observance of clean air and water statutes, providing for the personal growth of citizens, including minorities and the disadvantaged, and many other socially desirable outcomes. However, modern political cynics would quickly label this list as trivial. Indeed, a more accurate description of the

activities of governments is obtained by relying on Jensen and Meckling's original description of the motivators of mankind and the goal of an organization.

Jensen and Meckling assume that the behavior of all parties, both principals and agents, is motivated by self-interest. As mentioned earlier, they make no claim that this is morally superior, in fact, they state that "We focus almost entirely on the positive aspects of the theory."²³ However, utility of wealth maximization remains the single human motivator in their entire theory.

Government decision-makers, in their role as principal, would have the same motivation. While politicians may espouse the goals and social vision enumerated above, they have individual goals and perquisites that will sometimes take precedence. These would include such items as campaign donations from corporations and public interest groups affected by proposed legislation, endorsements, publicity, and other perquisites that individuals and corporations may from time to time provide. In situations where societal goals are in conflict with individual benefits, citizens should not be surprised if the former are sometimes sacrificed.

Jensen and Meckling also point out that the personalization of organizations implied by asking questions such as "What should be the goal of the organization?" is misleading. Organizations, in their role as principals, are not individuals. They serve merely as a nexus of contracts. Their motivation is as multi-faceted as the agents who manage them and the resource suppliers with whom they contract. This certainly applies to government in its role as principal. It explains, to a large extent, why governmental bodies can sometimes take such frustrating and contradictory actions as providing

²² Jensen and Meckling, *op. cit.*, footnote 14.

²³ Jensen and Meckling (1976), page 83.

subsidies to tobacco growers while suing tobacco firms in court for their impact on public health.

In their role as principals, governmental bodies must monitor the activity of their agents (firms). This monitoring activity can take the form of licensing (and the review of corporate actions prior to license renewal), environmental audits, inspections of corporate facilities and financial records, the submission of reports to regulatory bodies, and a host of other activities that businesses generally decry as "interference." Such monitoring carries a significant cost, and, as Jensen and Meckling point out, this cost is generally borne by the agent, not the principal. For this reason, agents have an interest to minimize these costs. They can be relied upon to act in a trustworthy manner in such activities, since acting in this manner will minimize agency costs. Firms can be relied upon for this behavior even if they are opposed to the entire regulatory process. Agency theory thus gives us a purely secular rationale for ethical behavior, a rationale fully consistent with the principles of agency theory, and a rationale that is consistent with the fallen nature of mankind as evidenced by the imperfect nature of his motivation (self-interest). In this regard, agency theory is unique among secular theories of business.

IV Government and the Firm in God's Kingdom

With these revisions, agency theory contains much to commend it. It deserves consideration from Christians and non-Christians alike, as it provides a basis for ethical behavior.

The revised view rests upon two properties that are crucial to the development of an ethical perspective in finance. It is consistent with the social institution view of the

firm, which emphasized the firm's origins as an institution ordained by society. Jensen and Meckling argue that agency theory stems from the property rights literature of Coase and of Alchian and Demsetz, and they would probably object to the social institution view of the firm.²⁴ Jensen and Meckling's emphasis on property rights is appropriate so long as the firm's role is defined solely as a principal. It is not necessary when the firm's role is defined in a broader context, as principal in some of its relationships and as agent in others.

The revised view of agency theory is also consistent with the requirement that ethical behavior requires individual responsibility. Jensen and Meckling rightfully insist that discussions of "the goal of the firm" and "the corporate conscience" are misplaced, since the firm is not an individual and is not morally accountable as individuals are accountable. Agency theory places the responsibility for corporate actions squarely on the shoulders of corporate agents who manage the firm.

Scriptural teachings tell Christians that they too are responsible for their actions. Jesus says "But I tell you that men will have to give account on the day of judgement for every careless word they have spoken."²⁵ Paul points out that "Each of us will give an account of himself to God."²⁶ Peter also warned us against the ways of pagans, indicating that "They will have to give account to Him who is ready to judge the living and the dead."²⁷ Obviously, we will all be called to give account on the judgement day, and we are all responsible to the Lord for our choices and our beliefs. No true system of ethics can ignore this fact.

²⁴ See list of References for full citations.

²⁵ Matthew 12:36 (NIV)

²⁶ Romans 14:12 (NIV)

²⁷ 1 Peter 4:5 (NIV)

By defining the firm as an agent of society as a whole, the responsibilities of the firm to society are given sharper focus. Just as society granted the firm its charter (and its right to operate), it can remove that charter if the firm behaves irresponsibly.

Agency theory's description of the relationship between principals and agents mirrors, in many ways, the description of the relationship between God and mankind as described in the Scriptures. Agents are assumed to be motivated primarily by self-interest, while the Bible describes mankind, in its natural state, as universally tainted by sin. Neither party would seem to be a proper object for one's faith.

Neither agents nor mankind are perfectible through their own means. Agency theory shows us that principals impose costs on organizations in order to monitor the behavior of agents, who otherwise would consume excessive perquisites. Mankind also is not justified by works alone, but needs the sacrifice of Jesus on the cross to be found blameless in God's eyes. Indeed, the entire Old Testament can be summarized as a series of mankind's failures to find justification through the law.

Much of the literature on ethics seems to miss the fact that mankind is not perfectible. It seems to have, at its heart, the assumption that if only managers would follow some prescribed action or if only ethics could be given greater emphasis in the discussion of business affairs, then moral and ethical conduct would abound in the business world. Agency theory does not fall into this trap. It does offer words of encouragement, however, when it clearly depicts the burden of agency costs falling on the shoulders of the agents themselves. This shows agents (who are motivated by self-interested behavior) that it is in *their own self-interest* to minimize agency costs. One of the best ways to do so is to practice sound ethical and moral behavior. While the tone of

this discussion may disappoint idealists, it probably represents the fastest and clearest way to change the behavior of the largest number of individuals.

Finally, the role of government is best described with the same duality as the role of the firm. For just as the firm is both the principal (to suppliers of resources) and the agent (to society as a whole), government is both a principal (to social institutions, such as corporations), and an agent (to its citizens). As such, government would be bound to disappoint those who would place unboundless faith in its actions and motives. Its behavior is not purely altruistic, but like other agents and principals, its motivation is based primarily on self-interest. Citizens need to constantly remind themselves of the need to monitor the activities of their agents (government), lest these same governmental agents themselves "consume excessive perquisites."

V. A Final Word: In What Can We Place Our Faith?

If we can't completely trust corporations for ethical behavior, and we can't completely trust governmental officials, in whom is our trust properly placed? Once again, the Scriptures provide us with the answer. They tell us that God has a purpose, "But the plans of the Lord stand firm forever, the purposes of his heart through all generations."²⁸ They tell us that His purpose is for our benefit, "And we know that in all things God works for the good of those who love Him, who have been called according to His purpose."²⁹ And finally, they tell us that we can depend upon Him, "The Lord is

²⁸ Psalm 33:11 (NIV)

²⁹ Romans 8:28 (NIV)

the same yesterday, today, and forever."³⁰ This certainly separates God from human agents motivated by self-interest.

In this paper, I have reviewed central propositions of agency theory. I've shown that many of these propositions, while the subject of much criticism in the ethics literature in finance, are really not in conflict with Scriptural teachings. I have also shown how agency theory can be extended from its original boundaries found in the tradition of the property rights literature to encompass a broader role for the firm, one consistent with the fundamental requirements for ethical conduct. Finally, I have shown how this new conceptualization of agency theory is consistent with Scriptural teachings regarding the responsibility of mankind and his fallen nature.

Agency theory, as reconceptualized, provides a basis for ethical behavior. It focuses on the responsibilities of the firm to society as a whole. When a Christian understanding of Scriptural truths is added, it provides us with an explanation of why, even with this new view of agency theory, things might go wrong. Most importantly, in the litigious and immoral business world of the 21st century, it directs us to the One in whom we can ultimately place our trust.

³⁰ Hebrews 13:8 (NIV)

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