Guest editorial

Ethical finance and governance

This special issue provides a forum for new research that looks at the nexus of ethics, finance and governance within. Social scientists have devoted considerable attention to linking human behavior to economic and social forces. A shared belief among classical and neoclassical economists, backed by empirical evidence, is that ethics represents a relevant driver of behavior. Adam Smith introduces the concept of empathy in explaining human behavior in *The Theory of Moral Sentiments* (1759). *The Wealth of Nations* (1776) expands on this notion, with empathy serving as a corrective device for countering the potential adverse effects of the market mechanism in the allocation of resources. Early neoclassical models carry on the tradition of incorporating ethics as a moderating force to address the potential adverse effects of pure utility or profit maximization behavior (Jevons, 1871).

In a world with increased labor mobility, designing company strategies and policies that are consistent with cultural differences remains a serious challenge (García-Sánchez *et al.*, 2015). Carroll (1999) put forward a positive relationship between ethical behavior and company profits. Moreover, Tella and Weinschelbaum (2008) suggest that a reduction in unethical behavior in a society is associated with enhanced social capital, human capital and monitoring activities. Zingales *et al.* (2016) argue that integrity is the most important dimension of corporate culture that is related to a firm's financial performance. Interestingly, Zingales *et al.* (2016) report that a culture of integrity is weaker among publicly traded companies.

The ethical behavior of agents in the finance sector has come under increased scrutiny over the past several years. An in-depth examination of the issue of ethical finance and governance is particularly important given the alarming increase both in the frequency and severity of incidents of corporate fraud. The scandals associated with Enron, WorldCom and Lehman Brothers, as well as the Ponzi schemes of Allen Stanford, Bernard Madoff and others have served to undermine the confidence of investors and the public. Remarkably, Dyck *et al.* (2014) estimate that only one in four committed frauds is detected in the US market, and that about 15 percent of US firms were engaged in corporate fraud over the period 1996-2004. This is particularly troublesome for those who believe that the USA has the highest standards of monitoring and investor protection worldwide. Equally disturbing, they find that the annual cost of fraud among large US corporations is about $380 billion. For markets with weaker regulatory protection than the USA, these results are especially disconcerting.

Given the underdeveloped nature of financial markets and the banking systems of many countries (particularly emerging and frontier markets), alternative solutions for financing investments have appeared, including microfinance entities. Some major international banks have joined local microcredit providers to service this niche, both to demonstrate their commitments to social development, as well as for profit. Banks are increasingly rethinking their activities and criteria to finance projects and firms in developing countries. As highlighted by Gangi and Trotta (2015), the investment funds linked to social commitment aims, in times of economic crisis, show greater stability in their benefits than the funds whose sole aim is profit. It seems that the moral and economic values linked to ethics provide balance and solidity to the system while tempering the required freedom and search for profits in the markets.

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This special issue includes six empirical papers tackling a range of interesting research questions on ethical finance and governance, and using a variety of methodological and disciplinary perspectives. The first two are conducted using large samples of US firms, while the remaining four papers are conducted within the European context. These papers were carefully selected after going through a rigorous peer-review process. The first paper, "Board gender diversity and ESG disclosure: evidence from the USA" by Manita *et al.* (2018) examines the prediction from Freeman's stakeholder theory (Freeman *et al.*, 2010) that boarder gender diversity should have a positive effect on Environmental, Social and Governance (ESG) disclosure. Using a sample of blue-chip companies from the USA, the authors show mixed results with respect to the role of gender diversity on ESG disclosure. Manita *et al.* however, find support for the critical mass theory where the number of female directors has to exceed a threshold of 3 for gender diversity to have an economically important impact on corporate ESG disclosure policy.

The second paper by Belkhir *et al.* (2018), "CEO inside debt and the value of excess cash," analyzes the relation between debt like compensation and excess cash valuation in the US context. The empirical results corroborate the author's main prediction that excess cash holdings contribute less to firm value when shareholders expect their value to be destroyed due to conservative behavior of the managers. It would be interesting to examine whether this novel finding, reflecting the interaction between agency costs of debt and the firm's policy decisions, holds outside of the USA.

In the third paper entitled "Investigating the associations between executive compensation and firm performance: agency theory or tournament theory," Elsayed and Elbardan (2018) investigate the direction of the causality between executive compensation and firm performance. Adopting a multiple theoretical perspective in a sample of Financial Times and Stock Exchange (FTSE 350) companies, the authors report a greater influence of executive compensation on firm performance than the pay-performance framework.

In the fourth paper, "Control-ownership wedge and the survival of French IPOs," Derouiche *et al.* (2018) use a hand-collected data from the prospectus of over 400 French IPOs to examine whether and how excess control influences IPO survival. Consistent with the view that controlling shareholders with high control-ownership wedge have incentives to preserve their private benefits of control by increasing firm survival chances, the authors show that IPO survival is positively associated with the magnitude of separation between ultimate cash flow and voting rights. The authors also find that older IPOs are more likely to survive while riskier and underpriced IPOs are more likely to delist.

In the fifth paper entitled "Does shareholder-oriented corporate governance reduces firm risk? Evidence from listed European companies," Djoutsa Wamba *et al.* (2018) study the relation between corporate governance and systematic risk. To do so, the authors construct a corporate governance index, following Boncori *et al.*'s (2016) approach, for about 350 European firms over the period 2002-2014, and find a positive effect of corporate governance on volatility of financial profitability.

Gaio and Pinto (2018), the authors of the sixth paper, "The role of state ownership on earnings quality: evidence across public and private European firms," use a large sample of public and private European firms during the period 2003-2010 to examine the role of state ownership on financial reporting quality regarding the characteristics of conservatism and earnings management. The empirical results from this last paper suggest that state-owned firms are less conservative than non-state-owned firms, which is consistent with the idea that there is less need for accounting conservatism due to government protection. The authors also report that capital markets play an important role in shaping the relationship between state ownership and earnings management.

In particular, state-owned firms exhibit higher abnormal accruals and worse accruals quality than non-state-owned firms, suggesting that state-owned firms are not immune to capital market pressures.

Jean-Michel Sahut
Groupe IDRAC, Lyon, France
Samir Saadi
Telfer School of Management, University of Ottawa, Ottawa, Canada
Lorne Switzer
Department of Finance, Concordia University, Montreal, Canada, and
Frédéric Teulon
IPAG Business School, Paris, France

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