Corporate Philanthropy and Company Value

by Professor Ronald W. Masulis and Syed Walid Reza

Although companies regularly give away a large amount of money to charity, there is no clear evidence that such donations improve company revenues, performance, or shareholder wealth. Proponents argue that corporate giving is consistent with shareholder value maximization for a variety of reasons, including improvement of a company’s reputation among customers and enhancement of its standing with regulatory agencies and legislators. Counterarguments suggest that corporate giving often reflects conflicts of interests between shareholders and managers if managers support charities with corporate funds based on personal preferences or to enhance their personal reputation and social networks. This Giving Thoughts article seeks to assess the impact of corporate giving on company value and performance.

The Competing Theories

Two competing theories outline the effect that corporate charitable contributions can have on company value:

1 Profit maximization According to Peter Navarro, corporate giving could enhance company value in three ways:
   a Revenue enhancement
   b Cost reduction
   c Tax minimization

2 Agency theory If corporate giving is viewed as an area of potential conflict between managers and shareholders, agency theory implies that such giving does not yield greater expected revenue or lower costs than its dollar value but instead represents a diversion of corporate resources, which reduces company value on a dollar-for-dollar basis with the size of the charitable contribution.

* Note: This Giving Thoughts is based on Ronald W. Masulis and Syed Walid Reza, “Agency Problems of Corporate Philanthropy,” The Review of Financial Studies, forthcoming.
Corporate giving can also be symptomatic of broader governance problems at the company. Because it is difficult to measure the benefits that accrue to a corporation from charitable contributions, it is easier for CEOs to promote their personal preferences, and thus, corporate giving decisions can substantially depart from firm value and shareholder wealth maximization.

In their highly influential study of agency theory, Michael Jensen and William Meckling observe that when owner-managers reduce their firm ownership below 100 percent, they are incentivized to consume more corporate resources since they bear less than 100 percent of the cost. They therefore predict that corporate giving increases as chief executive officer (CEO) ownership goes down and vice versa. Jensen and Meckling also state that corporate governance practices typically constrain a CEO’s ability to exercise their own preferences, so if a CEO is able to direct corporate contributions towards social organizations that reflect his or her own preferences, it is one indication of weaker corporate governance at the company.

No existing study has measured the relationship between corporate giving and the private preferences of CEOs, assessed the impact of corporate giving on company valuation or performance, or analyzed the channels through which corporate giving affects company value. By addressing these issues, this study helps to identify which of these two alternative theories more accurately depicts the effects of corporate giving on company value.

Profit Maximization versus Agency Theory
This section describes the tests and analyses conducted to measure whether corporate giving is a profit-maximizing effort or a resource misallocation. The results are outlined after a description of each test. Readers can access detailed information about the empirical analyses in Agency Problems of Corporate Philanthropy.

The focus of this research is Fortune 500 companies as of April 17, 2006 and hand-collected giving data from the National Directory of Corporate Giving from 1997 to 2006. The final sample has 2,421 observations from 406 companies.

Agency theory trumps profit enhancement

Test The analysis looked at the association between corporate giving, and improved company value versus agency theory. The research includes an assessment of whether corporate giving is incrementally beneficial for a sample of companies with relatively large expenditures on advertising and research and development (R&D), as these companies are often assumed to benefit most from charitable contributions.

Results The research shows little support for the conventional idea that corporate giving is profit-enhancing. In particular, the results do not show a relationship between corporate giving and a company’s propensity to advertise, one of the main motivations for corporate giving in existing theoretical and empirical studies (e.g., Navarro (1988)). On the contrary, there is substantial evidence to support the idea that corporate giving is a resource misallocation. More specifically, the research shows that companies are more likely to contribute to charities that are affiliated with the CEO. The likelihood that a company will give to charities and the amount they give increases by 21.4 percent and 1.5 percent respectively when CEOs have an observable personal tie to charities.

A 10 percent increase in CEO ownership reduces the likelihood of giving by 40 percent and the amount of giving by 3 percent, indicating that corporate leaders with a greater shareholder interest see corporate giving as extracting value from the company rather than enhancing it. At companies in which CEOs are entrenched or able to avoid the discipline of the board of directors, this relationship is more muted, indicating a more severe issue of resource misallocation at companies exhibiting weaker corporate governance.

There is no evidence to suggest that corporate giving provides greater benefits to companies that spend incrementally more on advertising or R&D. In fact, the relationship between corporate giving and advertising and R&D expenditures is statistically insignificant.

Decline in corporate giving follows dividend tax cuts

Test This natural experiment measured the rate of corporate giving after the 2003 Tax Reform Act. This Act reduced the personal dividend tax rate from a maximum rate of 35 percent to 15 percent. Assuming that corporate contributions reduce a company’s profitability and share value (as shown in the previous test), CEOs who pursued their charitable preferences through corporate giving after this tax cut would have more to lose personally. To provide a more direct causal link between corporate giving and shareholder wealth, the experiment is repeated, focusing on how reductions in charitable contributions as a result of the tax cut affect dollar dividends two years later.

Results Corporate giving significantly declines after the 2003 Tax Reform Act. This result is more acute as CEO company ownership increases. CEOs with more to gain personally from company performance are less willing to direct company resources to charity, particularly when tax rates take a lower cut of their personal gains.
A $1 million USD reduction in corporate giving after the tax-cut year results in an increase of at least $6.4 million USD in dividends two years later.

**Corporate giving negatively impacts company cash value**

**Test** This examination addressed how corporate giving affects company value through its impact on the market's valuation of a company's cash holdings. Cash reserves can provide funds that allow managers to invest in projects that offer private benefits, but destroy shareholder value. As a result, shareholders may discount the dollar cash holdings of corporations that make charitable contributions, imposing an even greater discount on firms with weaker board oversight.

**Results** Corporate giving has a substantial negative impact on company value through its impact on cash. If a company’s charitable donations move from the bottom 25 to top 25 percent of corporate giving, shareholders’ value of a company cash holdings is estimated to be 8.1 cents lower. For companies with non-independent boards—where board oversight is expected to be weaker—the negative impact of corporate giving on company cash more than doubles. These findings are consistent with the argument that shareholders believe that the leaders of companies that provide higher charitable donations are misusing their cash reserves by donating them. Shareholders therefore place a lower value on such companies.

**Evidence of Corporate Giving Destroying Company Value**

Having documented that corporate giving is more likely to be an indication of resource misallocation than profit maximization, the next series of tests aims to address why and how corporate giving destroys company value.

**Corporate giving serves leaders’ private interests**

**Test** This analysis looked at whether corporate giving offers leaders an opportunity to remove value from the company for their own personal gain. This test investigates the frequency and level of corporate contributions to charities in which CEOs have clear ties, defined as holding positions as trustees, directors, or advisors.

**Results** Approximately two out of three companies that make philanthropic contributions also direct money to CEO-affiliated charities. The average cost to a company from such contributions is larger than the combined cost of CEO corporate jet use and other perks and is comparable to a CEO's promised cash severance payments.

Furthermore, CEO-affiliated charitable contribution levels decline if the CEO’s financial interests are more aligned with the interests of shareholders. These findings suggest that corporate giving can be considered a channel that serves leaders’ private interests.

**Disclosure of leader-affiliated contributions pushes stock prices below expectations**

**Test** This study analyzed investors’ reaction to the first time a corporation discloses a “charity award.” (A “charity award” is a corporate contribution in the name of its officers and directors for the benefit of a charity of their choice.) This test allows for an understanding of how investors perceive charitable contributions to organizations at which company executives and directors have ties. In revising the disclosure rules on compensation in 1992, the U.S. Securities and Exchange Commission (SEC) recognized such awards as a form of compensation and required firms to report them in proxy statements.

**Results** A company’s stock value falls below expectations after charity awards are announced. Figure 1 documents a three-day cumulative abnormal return (CAR) of -0.87% (p-value = 0.014) for firms that report charity awards for the first time during 1993–2010. This wealth loss exceeds the nominal value of the charity award, suggesting that shareholders take these announcements as an indication of a company’s future contributions and lower their valuation of the company as a result. The results could also suggest that shareholders reduce their assessment of the quality of a giving company’s overall governance.

**Figure 1**

**Stock Market Reactions to Charity Awards**

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* Cumulative average abnormal returns for the first disclosure of charity awards. The sample consists of 53 companies whose proxy statements are investigated during 1993–2010. Abnormal returns are calculated using the Fama-French-Carhart four factor model.

Donations to corporate foundations suggest weaker corporate governance

**Test** This analysis looked at corporations’ decisions to contribute to third-party charities or their own foundations and the effects of this choice on company value. Corporate foundations are tax-exempt non-profit organizations that receive irreversible donations from their sponsoring companies. The critical factor for these foundations is that they separate their own economic affairs from those of shareholders. This separation negates shareholder claims on any donations transferred to the foundations. Consider the case of the Lehman Brothers Foundation, for example. Although its sponsoring company was liquidated in 2008, the foundation still exists under the name of the Neuberger Berman Foundation. In the year of liquidation, the foundation had a market value of assets of US$23.4 million, which was not distributed to company shareholders. As of November 2012, the foundation still uses these assets for philanthropic purposes. In addition, while the cost of the donation is immediately borne, information about the charity receiving it may initially be unknown or even seriously delayed.

**Results** Companies appear to give to foundations more when the CEO has a higher preference for charitable contributions (charity connections) and in situations of weaker corporate governance. Companies with stronger corporate governance typically provide a higher proportion of annual giving directly to end-recipients, not company-affiliated foundations. These results suggest that the adverse impact of corporate giving on company value is largely due to sizeable, irrevocable donations to corporate foundations.

Larger charitable contributions mean higher CEO compensation

**Test** This study looked at the relationship between CEO compensation and corporate giving. The test uses natural disasters in a company’s headquarters state as an external shock inducing a short-term rise in corporate giving and examines the subsequent effects on CEO compensation.

**Results** A 10 percent increase in giving is associated with a $523,500 rise in CEO compensation. This evidence indicates that the probability of a company paying abnormally high CEO compensation is significantly higher when companies make large charitable contributions.

CEOs use charitable donations to improve ties with independent directors

**Test** This analysis attempted to determine whether CEOs direct charitable contributions to particular organizations where independent directors have ties and the effect this has on CEO compensation. The research looks specifically at whether corporate-supported charitable causes overlap with the charitable interests of independent directors and whether there is a more direct form of entrenchment if CEOs use company donations to support the charitable interests of independent directors.

**Results** There is a 69 percent overlap between corporate-supported charitable causes and the philanthropic interests of independent directors, indicating that a strategic use of corporate giving is to support independent directors’ charity interests, which thereby strengthen their ties to a CEO. This finding supports the idea that CEOs use corporate resources to build ties with stakeholders to receive favorable treatment during future contract renewal or turnover decisions. This particular alignment of charitable interest is also positively associated with excess CEO compensation, suggesting that corporate charitable contributions advance CEOs’ private interests. A similar overlap of corporate giving and director charity ties is not found for other non-independent corporate directors.

Conclusion

This study clearly shows that CEOs gain from corporate giving, and CEO ownership and personal charity connections provide a significant explanation for a company’s level of corporate giving. The data indicates that 62 percent of firms contribute to CEO-affiliated charities with more affiliated contributions at companies where CEO financial interests are less aligned with shareholders. Corporate giving correlates with the self-interest of CEOs in several ways:

- CEOs appear to opportunistically transfer contributions to charities, and these large transfers reduce shareholder cash flow rights significantly.
- CEOs substitute cash dividends for corporate giving when a dividend tax cut increases a CEO’s economic gain.
- CEOs appear to use corporate giving strategically to support charities where independent directors have affiliations, which can strengthen the CEO’s social bonds with these directors.
The results support the theory that corporate giving is not a profit-maximizing tool but a resource misallocation problem, particularly when leaders have considerable influence over how and where corporate contributions are channeled. Such forms of corporate giving serve the personal interests of CEOs and compromise the independence of outside directors and result in lower stock returns. An SEC requirement to promptly disclose insider-affiliated corporate giving could help limit activities that divert value from shareholders toward company leaders, thereby benefitting outside minority shareholders.

Other research opportunities

Several interesting avenues of research remain unexplored:

1. Employee matching-grant programs are quite common, but do they enable companies to hire and retain higher-quality employees? If so, do they increase company profitability, or are matching programs merely part of a long-held, but ineffectual cultural tradition?

2. Legal professionals tend to differentiate corporate giving from CSR activity, while many companies “claim to have embraced CSR and then point to the glossy reports of their company foundation [grants] to demonstrate the degree of their commitment.”¹⁰ This highlights that one major form of CSR for many companies is corporate giving. Future research might examine whether shareholders understand such distinctions and demand that companies pursue activities which better position them competitively.

Endnotes

2. The classic example of corporate giving was at Occidental Petroleum where the founder, Armand Hammer, decided to build his own museum funded by the company, now known as the Armand Hammer Museum of Art and Culture Center or the Hammer Museum. In the case of one shareholder suit, Occidental agreed to limit the spending to $60 million for the construction of the museum and $35 million more for an annuity to be paid over 30 years.
4. There can be some expected revenue enhancement or cost reduction that are less than the cost of the corporate giving.
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