Corporate philanthropy in the US stock market: Evidence on corporate governance, value relevance and earnings manipulation

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Abstract

Article history:
Received 31 July 2014
Received in revised form 10 February 2015
Accepted 1 March 2015
Available online 10 March 2015

JEL classification:
M41

Keywords:
Corporate giving
Leverage
Litigation
Agency costs
Corporate governance
Value relevance
Earnings manipulation

This study examines the financial attributes of corporate philanthropy derived from the agency motives for corporate giving. Further, this study assesses the value relevance of corporate giving and investigates the impact of giving on investor perceptions and future profitability and growth. Also, it investigates the association between charitable spending and earnings manipulation. The findings indicate that the adoption of structured philanthropic initiatives and the use of in-kind contributions encourage corporate giving. Monitoring exercised by leverage and corporate governance affects corporate giving downwards. Firms that experience a management change are subject to more public scrutiny and tend to give more. Corporate giving is value relevant and is negatively related to analyst forecast error and positively to analyst coverage. Charitable firms tend to engage less in earnings manipulation. However, firms with significant growth options may direct slack resources to discretionary charitable causes. In-kind contributions are negatively related to managerial opportunism.

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1. Introduction

Corporate philanthropy may be expressed as cash donations given to charities directly by the company or indirectly through a company-sponsored foundation, and/or as in-kind gifts of a company’s products, services, infrastructure, or know-how (Seifert et al., 2003). According to Giving USA 2012, charitable giving accounted for 2% of GDP in 2010. Giving USA 2012 reports that, in 2011, 73% of charitable giving came from individuals ($217.79 billion), 14% from foundations ($41.67 billion), 8% from bequests ($24.41 billion), and 5% from corporations ($14.55 billion). According to Giving in Numbers 2012, aggregate total giving has risen by 27% since 2009, the year in which companies reported the most significant retreat in corporate giving. Since 2009, one-third of surveyed companies have increased their giving by 25% or more.

According to Giving USA 2012, in 2011, the majority of charitable dollars went to religion (32%), education (13%), and human services (12%). In 2011, total (cash) giving as a percentage of pre-tax profits amounted to 0.95% (0.75%). Among the three giving types, non-cash was the most volatile, falling by 47% among companies giving less from 2010–2011 and increasing by 32% among companies giving more in that period. While cash giving and non-cash giving have both been on the rise, the proportion of cash to non-cash giving in aggregate has declined in recent years. Most companies cited general economic decline as the reason for a reduction in giving. However, in 2011, 45% of the companies that reported profit reductions increased their total giving. In 2011, 82% of corporate givers reported having a corporate foundation. According to the Center on Wealth and Philanthropy, foundation giving increased in 2011 to $41.67 billion, representing a 1.8% increase from 2010. According to The Chronicle of Philanthropy (July 14, 2013), the 10 companies that gave the most cash in 2012 are presented in Table 1.

Mescon and Tilson (1987) argue that corporate giving can be considered as a form of corporate social behavior. Boatsman and Gupta (1996) argue that corporate giving is not just about maximizing company profits or improving certain financial figures, for example, through specific tax benefits, but it is about improving a company’s social profile and picture. Corporate giving influences the social image of the company but is voluntary (Buchholtz et al., 1999). Corporate giving may be viewed positively by investors, market authorities, customers and the local community. Thus, although optional, it may be strongly recommended.

According to Seifert et al. (2003), corporate philanthropy may be motivated by the following considerations. Companies may give strategically in order to reinforce their bottom line. They may give because of social responsibility or legitimacy reasons, which would suggest that companies that perform well should support charitable activities (see Marquis et al, 2007). Another motivation for corporate philanthropy is to reinforce the CEO’s profile, which may be attained easily by giving away shareholders’ money. Companies may also engage in charitable practices due to other reasons, such as political costs, lobbying, or clientele considerations (Sanchez, 2000). Gordon and Khumawala (1999) identify that other motives that encourage corporate giving include appreciation of the cause, company profitability, discretionary accruals, religion, and altruism.

Corporate philanthropy is significantly explained by the stakeholder theory in the sense that it is a way for companies to display their social responsibility to the local community and satisfy stakeholders’ interests (Berman et al, 1999; Clarkson, 1995). This study is mainly based on agency theory, which suggests that managers gain through corporate giving, and on value enhancement theory, which argues that corporate philanthropy increases shareholders’ wealth. The motive to finance philanthropic causes in the effort to enhance a company’s social responsibility profile may be regarded as an agency cost since the act of ‘good’ by managers may create opportunity losses for shareholders. That is why powerful shareholders may generally be in favor of lower levels of corporate giving (Bartkus et al, 2002). Nevertheless, strategic philanthropy (Useem, 1988) would align the interests of those against with those in favor of corporate giving reducing any reservations or conflicts and leading to a new equilibrium (Buchholtz et al, 1999).

Previous research on corporate philanthropy has concentrated on the association between corporate giving and taxes, company earnings, government incentives and market conditions (e.g. Boatsman & Gupta, 1996; Galaskiewicz, 1997; Seifert et al, 2003). This is the first study to link corporate giving to earnings manipulation and value relevance. It examines the financial attributes of corporate philanthropy derived from the agency motives for giving. It assesses the value relevance of corporate giving and investigates the impact of giving on investor perceptions and future profitability and growth. Also, it investigates the association between charitable spending and earnings manipulation. The US, which is the focus of this study, is shareholder/investor oriented, has strong investor protection mechanisms and effective corporate governance structures in place, and promotes adequate and relevant disclosures of corporate giving.

The findings indicate that the adoption of structured philanthropic initiatives and the use of in-kind contributions encourage corporate giving. Monitoring exercised by leverage and corporate governance affects corporate giving downwards. Firms that experience a management change are subject to more public scrutiny and tend to give more. Corporate giving is value relevant and is negatively related to analyst forecast error and positively to analyst coverage. Charitable firms tend to engage less in earnings manipulation. However, firms with significant growth options may direct slack resources to discretionary charitable causes. In-kind contributions are negatively related to managerial opportunism.

This study contributes by providing evidence that the public scrutiny to which charitable spending is subjected has reduced the scope for earnings manipulation, even if charity givers display low liquidity and high leverage. This study implies that stricter charitable giving-related disclosures would be needed in order to mitigate the potential for earnings manipulation especially for firms with significant growth options that may be tempted to use financial surpluses for discretionary philanthropic causes. This study also distinguishes between in-kind and cash contributions, and indicates that, since in-kind contributions do not influence liquidity levels and thus do not generate opportunistic behaviors, they may be used as a monitoring tool to reduce the levels of and the potential for managerial opportunism.

The remaining sections of the study are as follows. Section 2 presents background considerations. Section 3 shows the research hypotheses. Section 4 presents the datasets and limitations of the study. Section 5 discusses the empirical findings, and Section 6 presents the conclusions of the study.

2. Background considerations

2.1. Attributes of and motives for corporate giving

Higher liquidity would be positively linked to corporate giving (Pallot, 1990; Parsons & Trussel, 2008). Higher levels of debt would reduce free cash flows and limit the potential for wasting resources or discretionarily misdirecting funds (Brown et al, 2006; Harvey et al, 2004; Zhang et al, 2010). Thus, high leverage and strict debt covenants are likely to reduce corporate giving (Brown et al, 2006; Zhang et al, 2010). Higher debt would signify that lenders exercise greater monitoring, and thus corporate giving would be more credible. Therefore, corporate giving would be expected to be of higher quality and to a greater extent targeted to objective and real causes.

Higher adequacy of equity (net assets) would reflect companies’ ongoing ability to make donations (Trussel & Greenlee, 2004). High growth prospects would show that companies possess certain competitive advantages and managerial skills, which may lead to positive market values and stock returns and encourage them to give to charity. It could also be argued of course that growth companies may give less in order to use excessive cash for their growth potential, implying that corporate giving is a managerial decision that is highly discretionary. Corporate giving would also be influenced by market structure and market conditions. For example, companies that operate in a highly competitive market might earn lower or zero abnormal returns, which may limit corporate giving.

Companies with diverse sources of revenue would possess a more stable income stream, which would maintain and reinforce their corporate giving in the long-run (Greenlee & Trussel, 2000; Parsons & Trussel, 2008; Trussel & Parsons, 2008). Galaskiewicz (1997) found a positive relationship between corporate giving and return on sales, return on assets and return on equity. Also, income tax considerations are very important when deciding the amount and the target of corporate giving
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