# Board Composition and Corporate Philanthropy

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ABSTRACT. Using agency theory, this study empirically examined the relationship between board composition and corporate philanthropy. Generally, the ratio of insiders to outsiders, the percentage of insider stock ownership, and the proportion of female and minority board members were found to be positively and significantly associated with firms' charitable contributions.

Boards of directors are one of the greatest innovations of corporate America (Johnson, 1990) and have served society well for more than a century (Mace, 1972). All publicly held companies – large, medium, and small – are required by the general corporate laws of the states in which they are incorporated to have boards of directors. Directors' principle role underlying the legal perspective is to be accountable to the shareholders and protect shareholders' interests. This fundamental assumption is evident in a Delaware court statement, ". . .directors are fiduciaries in relation to the corporation and its shareholders, not as individuals, but as a class" (Lorsch and MacIver, 1990, p. 11).

In the past several decades, however, both practitioners and academicians have sharply criticized corporate boards. Boards have been blamed, at least partially, for the loss of competitiveness of American companies in the global market and the undervalued market prices of stocks as well as for the associated wave of takeovers and restructuring. A former executive vice president and director at General Motors put it, "U.S. boards grew fat, dumb, and comfortable on a diet of post war stability and prosperity," and he urged saving corporate America "by shaking up its boards" (Johnson, 1990, p. 46).

Over the years, numerous recommendations of boardroom reform have been proposed. Some of these recommendations call for separating the position of CEO and chairman, redefining directors' constituent responsibilities, reducing the number of directors, asking all insiders on the board other than the CEO to resign, requiring directors to own a substantial amount of stocks relative to their compensation, and redefining precisely what directors should or should not do as well as establishing criteria for board evaluations (Drucker, 1973; Lorsch and MacIver, 1990; Mace, 1972; Vance, 1964, 1983).

The most frequently proposed boardroom reform is to increase the representation by outsiders, directors who are not current or retired employees of the company on whose board they serve (Vance, 1964). According to advocates of this position, corporate boards should have majority outside directors because a higher proportion of outsiders can strengthen a board's independence, provide greater breadth of knowledge and experiences, and enhance the effective functioning of the board (Bacon and Brown, 1973; Williams and Shapiro, 1979).

The outsider dominance perspective has received theoretical support from several disciplines such as finance, organization theory, and strategic management. According to the agency theory, for example, a higher proportion of outsiders on a board can better monitor and control the opportunistic behavior of the incumbent management, thus, minimize the agency problem and maximize shareholders' wealth (Fama and Jensen, 1983a, 1983b; Jensen and Meckling, 1976).

During the 1970s and 1980s, corporations, volun-

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tarily or involuntarily, made drastic changes in the composition of their boards of directors. Today, most publicly held large companies have 75 percent or more outsiders on their boards (Lorsch and MacIver, 1990; Neff, 1989). Despite the popularity of the outsider dominance perspective, the adoption of government rules and regulations, and the dramatic changes made by corporations, practitioners continue to criticize the lack of independence and ineffective functioning of corporate boards (e.g., Johnson, 1990; Neff, 1989). Similarly, corporate governance researchers remain unconvinced that firms actually benefit from an increased number of outsiders on boards. Extensive research has been conducted over the past four decades to examine the relationship between board composition and various aspects of corporate performance (see Zahra and Pearce, 1989, for a comprehensive review). In summary, research on board composition-performance yields rather mixed results and overall findings seem to suggest that inside directors, not outside directors, are essential to firms' performance (e.g., Cochran *et al.*, 1985; Kesner *et al.*, 1986; Singh and Harianto, 1989; Vance, 1964).

The purpose of this study is to examine from an agency theory perspective the relationship between board composition and corporate philanthropy. Specifically, do increases in outside directors influence corporate charitable contributions? Does stock ownership by directors influence corporate philanthropy? Do women and minority directors differ from other directors regarding this issue? Agency theory is used to examine these questions since boards, *de facto*, carry out their activities in a principal-agent context. Corporate philanthropy is an issue about which principals and agents are likely to have conflicting views; thus, an examination of this question may provide information central to the debate concerning board composition.

## Theoretical background

### *Agency theory*

Deeply rooted in economics and developed in the domain of finance, agency theory emerged in the 1970s as a powerful framework to address the conflicting relationship between owners and managers and to suggest possible resolutions. In a recent paper, Eisenhardt argues that "agency theory provides a unique, realistic, and empirically testable perspective on problems of cooperative effort" and she urges organizational scholars "to use agency theory in their study of the board range of principal-agent issues facing firms" (1989, p. 72).

According to Jensen and Meckling, an agency relationship is defined as a "contract under which one or more persons (the principal(s))engage another person (the agent) to perform some service on their behalf which involves delegating some decision making authority to the agent" (1976, p. 308). Agency theory assumes that principals and agents have different self-interests and try to maximize their own utility. Principals are profit oriented because they have direct residual claims on a firm's earnings while agents tend not to be profit driven. Agency theory also assumes that principals and agents have different attitudes toward risk. For example, principals, who are capable of diversifying their investments, have a more liquid position than agents in the event of a takeover. Thus, principals should be risk neutral. Alternatively, agents, unable to diversify their jobs, should be more risk averse than principals. The risk difference argument supports the notion that principals and agents tend to have conflicting goals. Thus, the separation of ownership and control induces management or agents to exhibit different self-interests, different attitudes toward risk, and conflicting goals with owners or principals. If agents do not own substantial stock of the company or are not closely controlled by principals, agents are likely to engage in behavior that benefits themselves at the expense of stockholders. Examples of such opportunistic or shirking behavior include: managerial perks ranging from free lunches to private jets, investment in unprofitable projects, and excessive use of free cash flow (Fama, 1980; Fama and Jensen, 1983a, 1983b; Jensen, 1986; Jensen and Meckling, 1976). Consequently, monitoring what agents are actually doing becomes a central agency problem for the principals.

Within this perspective, an organization is viewed as "the nexus of contracts, written and unwritten, among owners of factors of production and customers" (Fama and Jensen, 1983b, p. 302). Agency problems arise "because contracts are not costlessly written and enforced" (Fama and Jensen, 1983, p.

327). Agency costs are defined as the sum of the monitoring expenditures by the principal (e.g., the use of boards of directors), the bonding expenditures by the agent (e.g., the preparation of financial statements), and the residual loss (Jensen and Meckling, 1976). Thus, the major task facing agency theorists is how to solve or mitigate these agency problems while at the same time preserving the beneficial aspects of the separation of ownership and control.

According to agency theory, "individual shareholders bear residual risk efficiently, but only to the extent that their collective interests are safeguarded by governance mechanisms" (Baysinger and Hoskisson, 1990, p. 75). Within this perspective, the board of directors is one of the monitoring mechanisms which "the stockholders within large corporations could use to monitor the opportunism of top executives" (Eisenhardt, 1989, p. 59). As Fama noted, the board's "most important role is to scrutinize the highest decision makers in the firm" (1980, p.294). Boards can fulfill their monitoring role because they "have the power to hire, fire, and compensate the top-level decision managers and to ratify and monitor important decisions" (Fama and Jensen, 1983b, p. 311).

Consistent with the outside dominance perspective, agency theorists call for an increasing number of outside directors on the board to monitor and control the behavior of top management. Fama views the outside directors as "professional referees whose task is to stimulate and oversee the competition among the firm's top management" (1980, p. 293). Outsiders, who are usually the decision makers of other organizations, have the potential to carry out the task of stimulating and monitoring the incumbent management because they are disciplined by the efficient managerial labor market "which prices them according to their performance as referees" (Fama, 1980, p. 294).

### *Empirical studies applying agency theory*

Agency theory has been used by several researchers to study board performance (e.g., Atkinson and Galaskiewicz, 1988; Baysinger and Butler, 1985; Kosnik, 1987; Lambert *et al.*, 1985; Singh and Harianto, 1989). For example, Baysinger and Butler (1985) examined the financial performance of 266 U.S. firms over a 10-year period and found that the relative independence of boards, measured by the proportion of outside directors, had a lagged and positive effect on firms' average return on equity.

Kosnik (1987) compared the boards of 57 firms and their position on greenmail payments. Boards which resisted payment of greenmail had more outsiders and outsiders with executive experience or contractual relationships with the firms. Singh and Harianto (1989) examined the characteristics of top management and boards of directors in large firms that have adopted golden parachutes. Comparing these firms to an industry- and size-matched control group, results indicated firms with experience of a takeover threat and relatively higher diffusion of stock ownership are more likely to adopt golden parachutes. Thus, as Eisenhardt (1989) recommended, these studies support the use of agency theory in the study of board issues.

## Hypotheses

Corporate philanthropy is an issue about which principals and agents are likely to have conflicting views. The issue has been exacerbated by ambiguity over the benefits of charitable contributions. While some argue firms incur unnecessary costs by giving away shareholders' money (e.g., Ullmann, 1985), others contend companies actually benefit from corporate philanthropy in terms of employee morale and productivity (Parket and Eibert, 1975), satisfaction of various stakeholders (Cornell and Shapiro, 1987), improved managerial skills (Alexander and Bucholtz, 1978), and enhanced corporate reputation and image (McGuire *et al.*, 1988). Given that corporate philanthropy offers no obviously direct financial benefit to shareholders, the agency theory perspective suggests that boards, as monitors of top managements' opportunistic behavior, differ in philanthropic giving by the proportion of insiders to outsiders and by ownership patterns.

The first hypothesis examines the extent to which the proportion of insiders to outsiders affects charitable contributions. The agency theory framework suggests that agents are more likely than principals to make charitable contributions because they have no direct residual claims on a firm's income. In other words, agents tend to be more generous than owners

because they are not giving away their own money. Furthermore, driven by self-interests, agents are more likely than principals to make corporate gifts to pursue nonprofit goals and secure their positions. In the presence of outsiders, the behavior of insiders would be more closely monitored. Thus, insiders will have less freedom and discretionary authority to pursue their own interests at the expense of shareholders. By reasoning from an agency theory perspective, it is hypothesized that:

**Hypothesis 1:** The ratio of insiders to outsiders on boards will be positively related to corporate philanthropy.

An additional consideration is whether insiders own stock in their firms. The higher their ownership stake, the more likely insiders will share the same goals as other stockholders. As ownership increases, agents should behave more like principals. Thus, increases in the percentage of stock owned by insiders should cause insiders to be more sensitive to the impact of charitable giving on profits. If charitable giving reduces owners' residual income then it is hypothesized:

**Hypothesis 2:** The percentage of stock owned by insiders will be negatively related to corporate philanthropy.

Another important issue is stock ownership by insiders relative to that of outsiders. While it is recognized that outsiders could bring a breadth of knowledge, experience, and objectivity to the board, they are often criticized for their ceremonial or rubber-stamping role and ineffective functioning. Despite the popularity of the outsider dominance perspective, empirical results are mixed. Some researchers have questioned the superiority of outside directors (e.g., Chaganti *et al.*, 1985; Cochran *et al.*, 1985; Kesner *et al.*, 1986). The ownership structure of boards, overlooked in previous board research, may partially explain the ineffective functioning of outsiders.

Although outsiders have a fiduciary responsibility to shareholders, they may have more incentive or a broader power base to monitor, influence, and even control the behavior of insiders when they own a higher percentage of stock relative to insiders. Thus, charitable contributions are expected to decline when ownership is concentrated with outsiders and the following hypothesis is implied:

**Hypothesis 3:** The ratio of stock owned by outsiders relative to that by insiders will be negatively related to corporate philanthropy.

The final hypothesis is related to the extent to which the proportion of women and minority directors affects charitable contributions. Some researchers have reported that the number of female directors on corporate boards is increasing (Elgart, 1983; Harrigan, 1981; Schwartz, 1980). Kesner argued that female directors are not "window dressing" and play an important role in the functioning of large corporations (1988, p. 80). Thus, the impact of the presence of women and minority directors is examined in this study.

Based on the previous research findings, it is argued that women and minority directors, whether insiders or outsiders, tend to be more sensitive to corporate social performance, thus, their board presence should have positive effects on corporate philanthropy. First, women and minority directors are more likely to represent special interest groups because of their social and economic background. According to Harrigan (1981), female directors typically have law, education, or nonprofit backgrounds. Hence, it is reasonable to expect that they are more sensitive to corporate social responsibility issues and the welfare of various stakeholders. Second, women and minority directors, because of their nonprofit orientation, tend to have goals that conflict with those of stockholders. Other studies have made similar observations; for example, Stultz noted that "unlike male directors,. . . women's careers are more diverse and less business-oriented" (1979, p.10). No claim is being made that women and minority directors shirk their responsibilities to shareholders, only that they are less profit-driven and more responsive to a greater variety of stakeholders than their counterparts. Thus, the final hypothesis states:

**Hypothesis 4:** The proportion of women and minority directors on a board will be positively related to corporate philanthropy.

## Research methods

*Sample and data*

The sample used in this study consisted of 78 Fortune 500 firms from the year 1984. The companies selected were dominant in the food, health and personal care, appliance, home products, oil, airline, hotel, and automobile industries. Information regarding charitable contributions and the number of women and minority directors was obtained from a report compiled by the Council on Economic Priorities (CEP) (1986). Information regarding board size, insiders, outsiders, stock ownership and total common stock outstanding was collected from 1984 proxy statements filed with the Securities and Exchange Commission (SEC).

*Variables and measurement*

The dependent variable, charitable contributions, was calculated as the percentage of pretax earnings given to charities. The four independent variables used to test the hypotheses include the ratio of insiders/outsiders, insider ownership, concentration ratio, and the proportion of women and minority directors. Inside directors were identified based on traditional classification by previous researchers (e.g., Pfeffer, 1972; Vance, 1964). An inside director was defined as a current or retired employee of a firm or one of its subsidiaries; all other directors were considered outsiders. The ratio of insiders/outsiders was obtained by dividing the number of insiders on a board by the number of outsiders. The insider ownership variable was measured by dividing total stock owned by insider directors by total common stock outstanding. The concentration ratio was determined by dividing the total stock owned by outsiders by the total stock owned by insiders. Finally, the proportion of women and minority directors was calculated by dividing the number of women and minority directors by the size of the board.

*Results*

As reported in Table I, the descriptive statistics revealed that the firms sampled averaged approximately 14 directors per board with a standard deviation of 3.6. The figure is consistent with previous findings (e.g., Kesner, 1988). The ratio of insiders/outsiders was about 70 percent. The average insider stock ownership per board was nearly 5.2 percent of the firm's outstanding common stock. The average ownership concentration ratio was about 3.7, which indicated outside directors owned almost 4 times more stock than insiders. Finally, the average proportion of women and minority directors was about 10 percent.

Multiple regression analysis was performed to test the relationship between board composition and charitable contributions. The detailed regression results, presented in Table I, show that the full model is statistically significant ($F = 3.891$, $p = 0.006$). The model explained 17.6 percent of the variance as evidenced by the $R$ square statistic. The regression diagnostics revealed that although some multicollinearity existed among independent variables, the problem was not serious with the average Variance Inflation Factor (VIF) much less than 10 (Neter *et al.*, 1985).

Supporting the argument derived from agency theory, Hypothesis 1 was confirmed with statistically significant results ($p = 0.042$), showing a strong positive relationship between the proportion of insiders to outsiders and firms' charitable contributions. Contrary to expectations, the percentage of common stock owned by inside directors was positively related to firms' charitable contributions. Hypothesis 2 was not confirmed; the result was statistically significant ($p = 0.011$). Hypothesis 3 was not supported since no linear relationship was found between ownership concentration and firms' charitable giving. Hypothesis 4 was confirmed with moderate statistical significance ($p = 0.105$). As expected, the proportion of women and minority directors was positively related to charitable contributions.

## Discission and conclusion

This paper examined the relationship between board composition and corporate charitable contributions from the perspective of agency theory. Some interesting results were obtained. Empirical evidence

TABLE I
Intercorrelations among the variables studied

| Variables | Means | s.d. | 1 | 2 | 3 | 4 |
|---|---|---|---|---|---|---|
| Percentage of Net Income as Charitable Contributions | 0.01 | 0.00 | | | | |
| Ratio of Insiders/ Outsiders | 0.70 | 0.60 | 0.29 | 0.36 | 0.16 | |
| Concentration Ratio | 3.70 | 13.30 | −0.05 | 0.12 | 0.28 | |
| Proportion of Women and Minority Directors | 0.10 | 0.08 | 0.16 | −0.18 | 0.06 | 0.03 |

* $N = 78$

suggests that the ratio of insiders to outsiders is positively related to corporate philanthropy. This finding is consistent with the argument that agents are more likely than owners to make charitable contributions in order to pursue self interests. The results also imply that outsiders play an important role in monitoring and influencing the behavior of insiders and in protecting stockholders. This finding has important implications for business strategists. From the perspective of corporate social performance, free-spending insiders accomplish favorable results by contributing to the improvement of society's infrastructure and the long-term relationship between firms and communities. If society can benefit from corporate philanthropy, are outsiders still needed to control what is already socially desirable behavior of insiders? From the perspective of agency theory, however, if one is worried about unnecessary expense and waste, free-spending insiders should be monitored by independent outsiders.

TABLE II
Results of regressions analysis predicting corporate charitable contributions

| Independent Variables | Beta | *P*-value |
|---|---|---|
| Ratio of Insiders/ Outsiders | 0.236 | 0.045 |
| Insider Ownership | 1.507 | 0.011 |
| Concentration Ratio | −0.001 | 0.771 |
| Proportion of Women and Minority Directors | 1.374 | 0.105 |
| $R^2$ | 0.176 | |
| F | 3.891 | 0.006 |

* $N = 78$

According to Jensen and Meckling (1976), principals are profit-oriented and agents are not, Therefore, they have conflicting goals. Agency theory stipulates that agents would behave more like owners and make fewer contributions as their stock ownership increases. This stipulation was not confirmed in this study. Results indicate that as the percentage of stock held by insiders increases, firms tend to give more funds to charities. These results challenge basic assumptions implied by the agency theory framework and raise the following questions: Do principals have nonprofit related interests? Do principals and agents always have conflicting goals? If so, from what perspective are these conflicts considered good or bad? Is agency theory too narrow for application in the study of corporate boards since it only focuses on economic issues?

Stakeholder theory may provide an explanation for the results of this study. Some researchers have acknowledged that firms have responsibilities over and above their fiduciary relationship to shareholders (Arlow and Gannon, 1982; Cornell and Shapiro, 1987; Freeman, 1984). While corporate philanthropy may not be in the best interest of stockholders, it may serve the interests of other stakeholders, such as the local community or the

general public. It is also argued that owners may have nonprofit interests. For example, owners (principals) may feel a moral obligation to society. Thus, socially responsible activities may become part of the overall business strategy and may be treated the same as other necessary expenses even though residual claims may decline.

The findings also indicate that the proportion of women and minority directors is positively related to corporate giving. The suggestion that women and minority directors are "less business-oriented" and more sensitive to corporate social responsibility issues is supported (Stultz, 1979, p. 10). Further, the findings support Kesner's statement that "women are not window dressing but do hold important positions on the boards of large corporations" (1988, p. 80).

In this study and previous research (e.g., Atkinson and Galaskiewicz, 1988), it was assumed there is no direct relationship between a firm's giving and its profitability. The hypotheses and subsequent interpretation of related results were based on this crucial assumption. Opposite interpretations could be made if the assumption were not correct. Based on results of this study, for example, the argument implied by agency theory would still hold true if there were a direct linkage between a firm's charitable contributions and its profitability. This issue and the relatively small sample size limit the generalization of the findings and call for cautious interpretation. In conclusion, this study utilized an agency theory approach to investigate the relationship between board composition and corporate philanthropy. The interesting findings should provide impetus for future research.

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