Agency Problems, Information Asymmetry, and Socially Responsible Investing in the Wake of Citizens United: A Call for the Disclosure of Corporate Political Contributions in the United States

Abstract: This paper argues that with the pervasiveness of socially responsible investing (SRI) and in the wake of the Citizens United decision by the U.S. Supreme Court, economic and public policy environments have dramatically changed. Consequently, in order to fulfill one of accounting’s primary functions (i.e. providing credible information that can be used in monitoring and bonding activities to decrease total agency costs), today’s reports should disclose political contributions made by SEC-filing corporations. In the absence of such disclosure, firms may engage in a new kind of agency problem not anticipated by standard financial and accounting theories: that of agents pursuing profits in ways that are in direct opposition to the preferences of the firm’s ownership.

Keywords: Agency theory, disclosure, political contributions, socially responsible investing, Citizens United, business lobbying, accounting theory.
INTRODUCTION

A central purpose of accounting disclosure, as well as a motivation underlying the engagement of independent auditors, is the mitigation of the agency problem identified by Jensen and Meckling (1976). Since the publication of that classic paper, the agency problem resulting from the separation of ownership from control has been typically characterized as managers maximizing their personal utilities at the expense of shareholders. Excessive perquisites, shirking behavior, empire building and the problems of over-investment are commonly cited examples of the agency problem. As Jensen and Meckling demonstrate, one consequence of information asymmetry is a lack of effective monitoring which allows unconstrained managers to consume resources in order to increase their utility, reducing shareholders’ wealth because of the wasteful spending. To reduce the asymmetry of information, the FASB mandates - and the SEC requires - the production of reliable and readily-accessible financial statements by publicly-traded firms, leading to better monitoring and a lower level of total agency costs.¹

In this paper, we argue that the economic landscape has changed since 1976 in two important ways which we believe should lead the accounting profession and securities regulators to consider a broader mandate for disclosure that includes the reporting of political contributions and lobbying expenditures by public corporations. The two changes that underlie our call for greater transparency are the rise of socially responsible investing (SRI) and the U.S. Supreme Court’s Citizen United ruling. This call for additional disclosure is particularly timely given the Financial Accounting Standards Board’s (FASB’s) current Disclosure Framework project, which

¹ We refer to “total agency costs” because the costs of preparing financial statements and procuring assurance services may themselves be viewed as agency costs, because they are incurred at least in part to lower other agency costs such as reducing the consumption of excessive perks within the firm. Therefore, costly information and monitoring agency expenditures may have a net benefit to the firm’s shareholders.
seeks “to improve the effectiveness of disclosures in notes to financial statements by clearly communicating the information that is most important to users of each entity’s financial statements” (FASB 2017).

**SOCIALLY RESPONSIBLE INVESTING**

Socially responsible investing (SRI) involves the consideration of not only the risk and return characteristics of a security, but also the underlying business practices. Thus, SRI adds “an additional set of guidelines […] to control the investment direction (or portfolio creation process), specifically guidelines which follow a moral or ethical doctrine” (Matloff and Chaillou 2013). As discussed in a recent webinar hosted by the Sustainability Accounting Standards Board,² SRI often seeks to avoid investment in certain corporations, such as those whose products are potentially harmful to individuals (e.g., tobacco or alcohol) or the environment (e.g., mining or oil refining), or may seek to invest in proactive firms, such as those “engaged in environmental sustainability and alternative energy/clean technology efforts,”³ or some combination of both. As this description suggests, investors oriented toward social responsibility may spend considerable time and effort evaluating the environmental and social performance of firms in addition to traditional analysis of risk and return. For these investors, SRI expands their

---

² “Behind the Scenes: How Asset Managers Use ESG Data,” July 14, 2015. Presentation slides from and a recording of the webinar can be accessed at http://fsa.sasb.org/webinars/?utm_campaign=FSA+Webinars&utm_source=hs_email&utm_medium=email&utm_content=20624000&_hsenc=p2ANqtz-8_7UaUozw6jMllWsm7iApq7EM48Ld8twt2PTTrsCn4Hv7X5OLQhBUcHr0pV4f0Pn60qVd_N5MOgjtjTQG4qxFbOorw&_hsml=20624000

information needs beyond the two-dimensional analytical environment of Modern Portfolio Theory,\textsuperscript{4} adding new non-financial criteria to the decision-making process.

The SRI movement has grown dramatically over the past decade. Professionally managed investment assets using environmental, social and governance (ESG) screens increased from about \$1 trillion in 2005 to \$5 trillion in 2015.\textsuperscript{5} SRI mutual funds reported assets of over \$600 billion in 2012, a dramatic increase over the \$12 billion under management in 1995 (Glassman 2012), but well below the \$2 trillion investors committed to these funds just two years later in 2014.\textsuperscript{6} Participation of investors has clearly grown in concert with the growth in funds. For instance, retirement fund manager TIAA-CREF has a socially responsible mutual fund (its Social Choice fund) holding almost \$3 billion of socially-screened\textsuperscript{7} securities. Institutional investor signatories to the Carbon Disclosure Project (CDP) increased from 35 signatories in 2003, managing \$4.5 trillion, to 655 signatories in 2012, managing over \$78 trillion (Thorpe 2013).

Firms are responding to the socially responsible investors’ desire for information by voluntarily reporting their sustainability and social responsibility performance. The leading reporting protocol for such disclosures was developed by the Global Reporting Initiative (GRI), with the number of firms filing GRI reports growing from 44 in 2000 to 3,653 in 2012.\textsuperscript{8} The number of

\textsuperscript{4} Markowitz, Sharpe and Lintner pioneered the foundations of modern portfolio theory and the capital asset pricing model, which were developed in the two-dimensional world where investors maximize return per unit of risk, subject to their risk tolerance.


\textsuperscript{7} Social “screening” refers to either “negative” screens that eliminate from consideration companies whose activities are considered inappropriate for inclusion in an SRI portfolio by the fund manager, while “positive” screens serve to identify companies whose activities are considered consistent the fund’s SRI objectives. For example, it was common during the apartheid era to exclude from SRI funds companies that conducted business with South Africa, and today one common positive screen is firms that adopt the labor standards for the treatment of workers in their third-world suppliers’ factories as stipulated in the UN Global Compact.

\textsuperscript{8} http://database.globalreporting.org.
companies reporting in the Carbon Disclosure Project (CDP) rose from 1,449 in 2005 to 4,112 in 2012, an annual growth rate of 23 percent over the six-year period (Thorpe 2013).

As these trends demonstrate, there are a growing number of investors who share concerns about the actions of corporations in ways that were not necessarily envisioned by traditional agency theory. Many of these investors may, in some circumstances, be willing to turn agency theory on its head: they may willingly sacrifice financial returns in order to enhance other dimensions of performance. These investors may prefer that management does not pursue all wealth-producing projects, specifically projects that may result in environmental or social effects that are counter to the socially responsible investors’ preferences. For example, a firearms manufacturer might consider the detrimental effect on profits if legislation were to be passed requiring the licensing of handguns. The firm might forecast that investing in political lobbying would be wealth-producing if they are confident that lobbying will decrease the likelihood of the legislation’s approval and the expected value of the preserved profits would exceed the cost of the lobbying effort.9 According to traditional financial doctrine, shared by Jensen and Meckling and advocated by Milton Friedman (1970), not pursuing the lobbying strategy in this case would be a violation of the corporation’s duty to its shareholders. In other words, the lack of political investment, in this example, could be seen as an agency cost of underinvestment from the perspective of traditional agency theory. In an SRI environment, it is reasonable to expect that many shareholders would object to their agents spending funds on projects that they find objectionable even if such projects could increase their financial wealth. If, for example, they are not informed of lobbying investments, these investors would not realize that their personal

---

9 It is conceivable that some individuals who invest in firearms makers are not opposed to the manufacturing of handguns yet they may feel that handguns should be licensed.
goals have been compromised by the same agents whom they may otherwise believe are acting on their behalf.

The recent rise in non-financial disclosure, particularly the reporting of environmental and social performance using platforms like the Global Reporting Initiative and the Carbon Disclosure Project, is clearly in response to concerns of corporate stakeholders, including employees, community members, customers as well as SRI-inclined shareholders. However, because socially responsible investors are diverse in what they consider to be desirable corporate behavior, the disclosure of political expenditures is an efficient way of addressing both the broad range of SRI concerns as well as focusing on the most direct and least-transparent methods that firms utilize for influencing their external business environments. As examples, some socially responsible investors are most concerned with environmental stewardship, motivating this group to likely filter out firms that lobby against environmental regulations, while other investors may focus on income inequality so they would like to know if companies in their portfolios are supporting candidates opposed to a more progressive tax structure.

**CITIZENS UNITED RULING**

This call for disclosure of political expenditures by firms clearly has practical public policy effects, particularly in light of “Citizens United.” Since the Supreme Court’s ruling in 2010 in the Citizens United case, corporations (as well as unions and other associations) can make unlimited contributions and lobbying expenditures that are intended to influence political decisions. The Court ruled that First Amendment free speech protections apply to for-profit corporations as if they were persons. However, as argued in Barone and Hickman (2012), there is an essential difference between natural persons and for-profit corporations that the Court failed
to consider: for-profit corporations strive to maximize shareholders’ wealth while natural persons seek to maximize their individual expected utilities. Thus, a natural person may rationally choose to forego a profitable opportunity and instead use some portion of her wealth for utility-producing consumption. Such consumption may take any number of forms including, for example, entertainment or charitable contributions. In contrast, a for-profit corporation is judged by its ability to produce wealth for its owners and, as any number of Finance textbooks will attest (e.g. Brealey and Myers 1984; Bodie and Merton 1998; Berk and DeMarzo 2011; and Keown, Martin, and Petty 2014), shareholder wealth maximization is their primary objective.10

This difference raises some concerns. If the political influence is positively correlated with wealth, then Wal-Mart Corporation, for example, could arguably yield as much wealth-related political influence as do all of its employees combined.11 Furthermore, in the traditional context, not making these investments may be viewed as an agency cost, as mentioned in the earlier discussion of SRI. There is a danger, therefore, that “purchases” of political influence by corporations may “squeeze out” the preferences of individuals. Here Barone and Hickman (2012) cite the incentives of corporate polluters to perpetuate market failures whose correction may require political initiatives. To illustrate this point, consider a carbon tax as a solution to the market failure associated with the negative externalities of CO2 emissions. In the pursuit of profit

---

10 The fundamental goal of shareholder wealth maximization is justified in Principles of Corporate Finance where authors Richard Brealey and Stewart Myers argue that, “Many corporations have hundreds of thousands of shareholders, no two with the same tastes, wealth, or personal opportunities. (...) The remarkable thing is that managers can all be given one simple instruction: Maximize net present value” (Brealey and Myers 1984, p. 20). Recently, the primacy of stockholders as the chief concern of the corporation has increasingly been challenged by the stakeholder model (Stout 2010) yet it remains the dominant narrative in most financial literature (e.g. Bodie and Merton 1998; Berk and DeMarzo 2011; and Keown, Martin, and Petty 2014).

11 Wal-Mart employs about 1.4 million people according to Forbes (http://www.forbes.com/sites/realspin/2013/11/27/why-do-1-4-million-americans-work-at-walmart-with-many-more-trying-to/), median net worth of an adult American was recently estimated at $44,900 according to a study cited by CNN (http://money.cnn.com/2014/06/11/news/economy/middle-class-wealth/), yielding an approximate aggregated net worth for Wal-Mart employees of about $63 Billion - a rough estimate that is several orders of magnitude below the market value of Wal-Mart’s equity of $270 Billion according to Yahoo Finance.
maximization, corporations may view expenditures to defeat any carbon tax initiative as their duty to pursue so long as the benefits outweigh the costs. Here the majority of the costs of climate change are actually borne by the firm’s stakeholders, including its shareholders, the majority of whom may actually prefer that the firm not oppose the legislation. Thus, climate change could continue unchecked in part due to the political clout of corporations, possibly contrary to the preferences of a majority of the same firms’ owners.

Without disclosure of a firm’s political investments, there is no mechanism for its shareholders to exercise their ownership right to change the firm’s strategy, or at least to divest themselves of the company’s shares so they are not financially supporting business practices to which they are opposed. Unlike the case of SRI, here any investor may find their political influence compromised by corporate activity now that the Citizen United case has untethered corporate political activism. Our call for greater mandated transparency in response to the Citizens United ruling mirrors growing concern from organizations such as the New York State Common Retirement Fund, which led several shareholder proposals calling firms to disclose their politically-related spending.\textsuperscript{12} In fact, The Forum for Sustainable and Responsible Investing reported that the leading SRI-related shareholder proposals for the period 2014-2016 called for disclosures of political spending and lobbying, outstripping the number of proposals related to climate change or human rights disclosures.\textsuperscript{13}

The efficacy of disclosure in curbing agency costs is supported by Pinghsun and Zhang (2012), lending credence to the argument that transparency will aid in reaching an informed equilibrium between corporate political expenditures and the preferences of the firm’s

\textsuperscript{12} See http://www.pionline.com/article/20150204/ONLINE/150209945/5-companies-to-disclose-political-spending-following-new-york-state-common-proposals
\textsuperscript{13} http://www.ussif.org/files/Infographics/Overview%20Infographic.pdf.
ownership. The United Kingdom has initiated reporting similar to the disclosure we are proposing. The UK’s Guidance on the Strategic Report (2014) requires reporting “…on political donations made or political expenditures incurred by the company or its subsidiaries, if in excess of £2,000 in aggregate.” Since the strategic Report is similar to our own MD&A, the U.K. provides precedence for the initiative as well as a model for fashioning the implementation of the disclosure.

CONCLUSION

The growth of socially responsible investing (SRI) implies the need for greater disclosure to facilitate the decisions of a sizeable segment of the investment community which considers the social and environmental implications of a security’s underlying business practices in addition to traditional financial performance metrics. We argue that disclosure of political contributions can provide socially responsible investors with the information they require for their expanded range of investment criteria.

Furthermore, the Citizens United ruling increased the information asymmetry between firms and all investors by obfuscating the political activism of the firm. For example, considering the potential effect that political contributions could have on blocking regulation that could mitigate environmental externality problems, Citizens United opened the door to agency costs by allowing unfettered political contributions by firms which may then conceal these expenditures from their investors who might prefer that such environmental issues be addressed. Clearly, the opposite could also be true, some firms may lobby for such environmental regulation which

---

could be in opposition to the wishes of their wealth-maximizing owners’ wishes, an instance of the traditional interpretation of the agency problem. Consequently, the court’s ruling extends the need for greater transparency beyond SRI to all corporate claimants.

We argue, therefore, that the accounting profession and reporting regulations should respond to this new business environment by requiring the disclosure of political contributions made by SEC-filing corporations. This call for additional disclosure coincides with FASB’s current Disclosure Framework project, which seeks “to improve the effectiveness of disclosures in notes to financial statements by clearly communicating the information that is most important to users of each entity’s financial statements” (FASB 2017). Until such disclosure of political contributions is mandated, firms may engage in a new kind of agency problem not anticipated by standard financial and accounting theories: the cost of agents pursuing profits in ways that are in direct opposition to the preferences of the firm’s ownership.
REFERENCES


