Compensation-Related Metrics and Marketing Myopia

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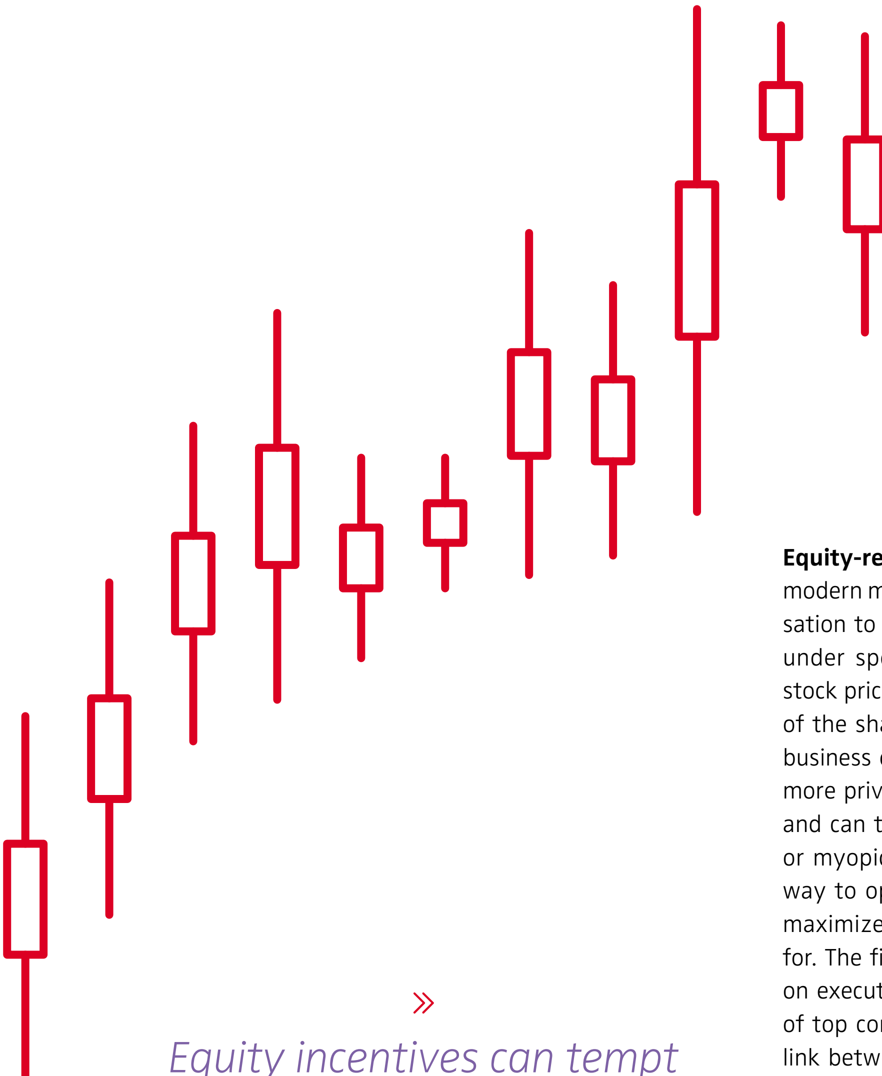
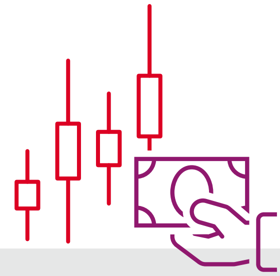


Equity incentives can tempt marketing executives to engage in short-sighted marketing management.

Equity-related compensation motivates executives In modern management, it is common to tie executive compensation to company performance and share value. In theory, under specific assumptions, if managers care about the stock price of their companies, they act in the best interests of the shareholders and make company value-maximizing business decisions. In practice, however, executives possess more private information about a company than the public and can take unobservable action like "creative" reporting or myopic management. As a result, they have some leeway to optimize their personal compensation rather than maximize the long-term value of the company they work for. The financial crisis of 2008 trained a piercing spotlight on executive compensation and its effects on the behavior of top corporate management. Critics have drawn a direct link between escalating executive pay packages and deteriorating business ethics, widespread excesses and abuses of power, and a disregard for the welfare of customers, employees and shareholders.

Equity-based compensation can lead to undesirable side effects In our study (Box 1) we took a closer look at the motivational power of equity-based compensation schemes. We focused on the marketing function and conducted a series of analyses to investigate how equity-based reward systems for CEOs and CMOs (chief marketing officers) affect marketing decisions. We found that compensation packages including incentives tied to a company's stock price can be powerful motivators for corporate leaders. But our study also showed that these motivations can produce some serious unintended consequences. Equity incentives can tempt CMOs to engage in short-sighted marketing management – such as cutting R&D and advertising spending – in an effort to inflate current earnings and enhance the company's

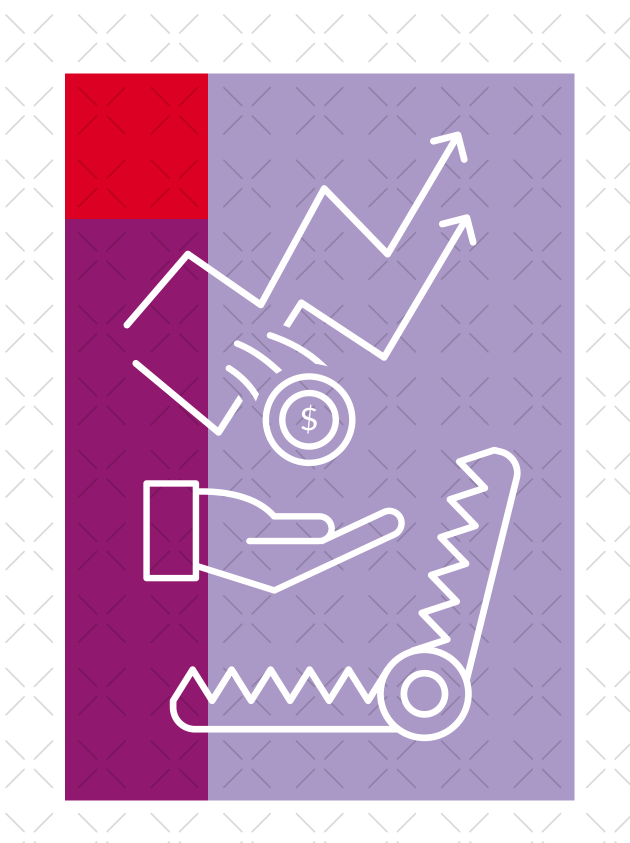


BOX 1

Studying causal effects of compensation on marketing decision-making

We combined and examined data from multiple sources on public companies and their leadership teams: executive compensation from ExecuComp, accounting data from Compustat, insider trading data from the Thomson Reuters Insider Filing Data Feed (IFDF) and stock returns from the Center for Research in Security Prices (CRSP). Our sample consisted of public companies and covered the period from 1993 to 2014. The research focused on CEOs and CMOs, who are most responsible for decisions on marketing, sales, advertising and innovation expenditures. These functions tend to be frequent targets for real earnings manipulation.

Our objective was to identify causal effects of executive compensation structure on management behavior and company performance. We found a specific type of misbehavior: increased equity-based compensation led to increased prevalence and severity of myopic management aimed at temporarily inflating earnings. More detailed findings are presented below.



stock price. This myopic management boosts their personal earnings at the expense of their company's long-term performance.

Equity compensation incentives of CMOs but not CEOs drive myopic marketing management × While CEO equity incentives appeared largely unrelated to myopic marketing management, the same kind of equity incentives offered to CMOs strongly predicted the incidence and severity of short-term earnings manipulations involving deflating spending on marketing and R&D. Cuts to marketing and R&D spending effectively boost current earnings, often resulting in a temporary increase in stock price. CMOs take advantage of inflated valuation by exercising more stock options and selling more personal equity holdings in the years when myopic management takes place.
This finding contradicts the popular pessimistic view of marketing's stand in organizations, questioning the ability of CMOs to influence a company's strategy (see Box 2). According to our findings, CMOs appear to have a significant influence on marketing budgets and company strategy. Our study also challenges the belief in the CMO as a central force to mitigate marketing resource misallocation and as the dominant advocate for a long-run-focused marketing strategy. When CMOs enjoy equity-based compensation,

BOX 2

The power of marketing and CMOs in today's organizations: Waxing or waning?

Independent of the potential abuse of managerial influence, a hot debate is going on about the general power and scope of the marketing function within organizations. One popular view is that the influence of marketing is waning. Supporters of this view highlight the inability of marketers to document marketing's contribution to the bottom line, an emphasis on short-term revenues, market share and stock price and a shift in channel power as the primary causes for this trend. Under this view, CMOs' compensation would be unrelated to myopic management because CMOs could be neither responsible for nor capable of directly influencing a company's strategy.

In sharp contrast, an alternative view sees a rising power of CMOs. In this view, marketers' credibility and power come from owning customer knowledge and market intelligence, and with the ever-increasing market complexity, the influence of marketing is only bound to increase. Understanding, managing and responding to market complexity requires highly specialized capabilities and skills, which are outside the scope of competency of generalist marketers at a strategic business unit level. Supporters of this view advocate building and strengthening the central marketing group with the key responsibility of overseeing market intelligence, data analytics and marketing decision-making, and they put the CMO at the center of this structure. CMOs would be the central force to mitigate marketing resource misallocation, create more coherent and linked marketing strategies, leverage success, and improve communication and cooperation within the organization. Indeed, without a centrally driven discipline, internal resource allocation may be driven by politics and personalities of the divisional and functional executives on the management board (CXOs) and firm resources may be diverted to the largest, rather than the most promising, areas and markets. Under this view, CMOs would be directly responsible for and capable of preventing myopic marketing management.

they show a tendency to engage in myopic marketing management and seek to derive personal gain when it occurs.

Negative long-term consequences of myopic management × When CMO compensation contains significant equity-based components, the reasoning of advocates for a strong marketing function does not hold. Contrary to the arguments that the presence of a CMO in the organization can help maintain customer focus and support for marketing departments, CMOs not only fail to prevent myopia but further exacerbate the problem as the market-based portion of their personal compensation increases. Our findings highlight the pitfalls and limitations of overreliance on equity in managerial compensation packages. Equity compensation can create perverse incentives for managers to engage in myopic practices. In our study, these effects were significant and sustained.

Myopic management is a serious problem and a threat to companies because it entails inefficient decision-making. The negatives include significant long-term declines in market valuation, innovation and future profitability.

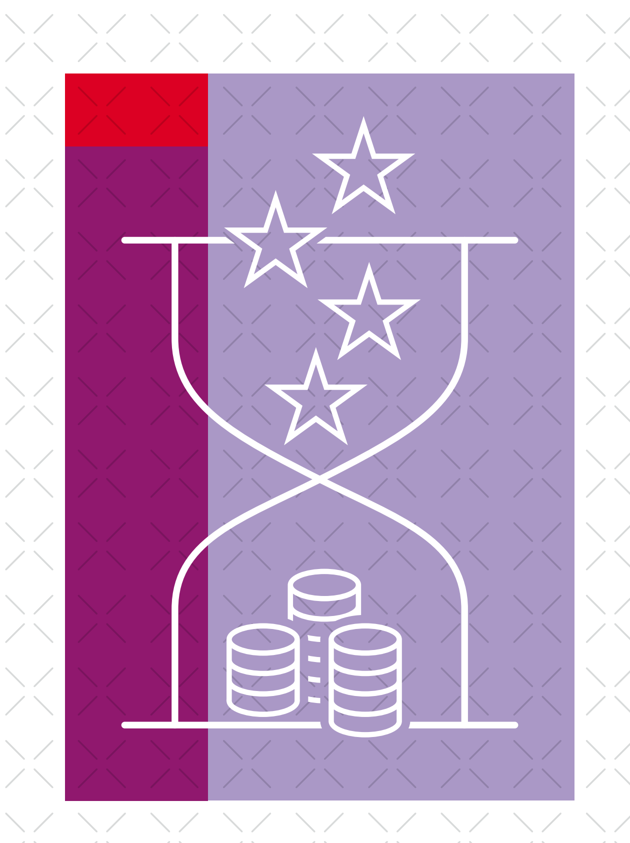
How to limit myopic marketing management × We see several potential solutions to address the misalignment of executive incentives and long-term company performance.

- **Extending vesting periods** × Despite the ubiquity of executive compensation packages featuring equity, myopic marketing management is not inevitable. Companies could continue to pay their C-level executives based on stock price performance but defer the payout to the future until the long-term consequences of their decisions become apparent. This would reduce the temptation to act on short-term impulses to boost equity compensation.

» *Corporate boards could tie executive compensation to long-run-oriented non-financial performance metrics such as customer satisfaction, brand equity or innovativeness.* «

- **Linking incentives and performance to alternative long-run-oriented metrics** In addition, corporate boards could balance performance measurement and tie executive compensation to long-run-oriented non-financial performance metrics such as customer satisfaction, brand equity, strength of the product pipeline or innovativeness.

- **Disclosure of non-financial performance indicators** Another deterrent to myopic management may come in the form of regulation that expands disclosure of non-financial performance indicators that are relevant to company value. For instance, environmental, social and governance (ESG) considerations have become increasingly important for investors to evaluate long-run implications of managerial decision-making. Specific disclosure in these fields has become mandatory in certain countries such as Australia, China, South Africa and the UK.



Test for unintended effects when using metrics in decision-making On a more general level, our findings demonstrate that while relying on share value to determine executive compensation seems to make a lot of sense at first sight, a closer look at potential side effects is advisable. This may hold in particular for managers such as CMOs who may be responsible for investments in intangibles that create immediate expenses but generate benefits in the future, such as competitiveness, innovation, customer loyalty and product market success.

FURTHER READING

Artz, M., & Mizik, N. (2017). How incentives shape strategy: The role of CMO and CEO compensation in inducing marketing myopia.
http://dx.doi.org/10.2139/ssrn.3093033