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Leadership

Locally Grown CEOs Manage for the Longer Term

CEOs from the state where their companies are based are less likely to cut R&D expenses in order to achieve earnings targets, research finds.

By David McCann

What confidence can shareholders have in top executives' ability to manage for the long run — as leaders might do, for example, in sustaining a company's investments in research and development even as they strive to meet earnings forecasts?

A survey some years ago of 400 CFOs found that about 80% would choose to reduce intangible spending, including R&D, to meet earnings targets, even though investment in intangibles is widely considered key to companies' future competitive success.

Indeed, failure to think for the long haul — so-called corporate myopia — has been widely lamented as an egregious shortcoming of contemporary management, and has evoked an array of proposals in response.

Mostly these involve providing financial incentives for top managers' to think long-term. For example, companies may use stock awards to increase executives' ownership of company equity. Or, they may have employment and severance agreements that increase the cost of firing top managers but benefit the company by motivating execs to undertake long-term risky projects where the potential payoff is some time away.

Now a study in the March issue of *The Accounting Review*, a peer-review journal of the **American Accounting Association**, suggests a way to encourage long-term corporate thinking that has been largely overshadowed by these financial stratagems: hire CEOs native to the state in which a company has its headquarters.

The paper, "East, West, Home's Best: Do Local CEOs Behave Less Miopically?" answers the title's question in the affirmative.

Researchers — Shufang Lai of Southern University of Science and Technology, Shenzhen, China; Zengquan Li of Shanghai University of Finance and Economics; and Yong George Yang of the Chinese University of Hong Kong — identified hundreds of U.S. CEOs who were born in the state that is home to their respective companies.

They concluded that, compared to other chiefs, "local CEOs are less likely to cut research-and-development expenses for beating analyst forecasts or avoiding earnings decreases. Various tests suggest that the relation is causal…. What is particularly worth noting is that the magnitude of the CEO locality effect is comparable to that of equity ownership as well as that of contractual protections such as employment agreements and severance agreements."

In some ways, in fact, the locality effect exceeds that produced by financial incentives.

For example, the professors tested how ownership of company stock affected the likelihood of CEOs' reducing R&D. They found that those with relatively high ownership (75th percentile) were about 4% less likely to do so than those with relatively low ownership (25th percentile).

In contrast to that modest difference, they found that, when a company switches from a nonlocal CEO to a local one, the likelihood of annual R&D reductions decreases by a much heftier 20%.

Local CEOs "need to overcome a higher emotional hurdle to take opportunistic short-term actions that risk their firms' long-term viability and eventually their local reputation," the professors wrote. “They have a much longer horizon in balancing short-term financial gains and long-term life and career outcomes.”

Yang observed that local CEOs have included such noted figures in corporate management as Berkshire Hathaway’s Warren Buffett, Apple’s Steve Jobs, Reebok’s Paul Fireman, and General Motors’ Mary Barra.

The study’s findings emerge from an analysis of R&D funding by 1,903 CEOs of S&P 1500 companies, 378 of whom were locals, during a 25-year period. Local was defined as being born in the state where a CEO’s company was headquartered.

As for why the study focused on R&D as a test of managerial myopia, the authors explained that U.S. accounting rules require that R&D costs (in contrast to capital spending) be immediately expensed, making for an immediate impact on accounting profits.

The professors’ analysis reveals that local CEOs are significantly less likely than others to reduce annual R&D spending in general. Perhaps more tellingly, they are also less likely to do so in order to beat analysts’ consensus earnings forecasts or to avoid having to report decreases in annual earnings.

In addition, companies with local CEOs have better financial performance and enjoy higher valuation. This suggests that local CEOs’ resistance to cutting long-term projects is not because they prefer a “quiet life” — that is, avoiding tough decisions — or face agency issues.”