University of Kentucky

Gatton College of Business and Economics

Institute for the Study of Free Enterprise

The Buffering Effect of Brands for Companies Facing Legislative Homogenization: Evidence from the Introduction of Sarbanes-Oxley

- **On average, corporations shifted their emphasis away from riskier R&D investments and towards safer marketing activities**
- **Increased corporate marketing expenses across industries led to decreases in marketing efficiency—the proportion of sales to marketing costs**
- **However, firms that invested in building their brand prior to SOX maintained more of their marketing efficiency**
- **In the future, Sarbanes-Oxley may make U.S. corporations vulnerable to innovative foreign competitors that can leverage their size without having to comply with the law**

Strong brands have been shown to often be catalytic in nature, enhancing the positive effects of other marketing initiatives. Furthermore, brands can ameliorate the negative impact of undesirable situations, such as service failures (Zboja and Vorhees 2006), negative publicity (Ahluwalia, Burnkrant, and Unnava 2000), and product recalls (Cleeren, Dekimpe, and Helsen 2008; Kalaignanam, Kushwaha, and Meike Eilert 2013). Given this joint benefit of both reinforcing positive and dampening negative firm consequences, as well as their own direct positive effects on firm outcomes, it is not at all surprising that "building strong brands has become a top priority for many organizations" (Keller 2001, p. 1). Moreover, since many managers are risk averse, understanding when brands can be expected to attenuate the effects of negative outcomes is particularly important.

The vast majority of past research attempting to understand the buffering role played by brands in the face of negative events has been firm-specific (e.g., a firm's recalled products, a firm's service failures). While this work is important, it does not assess the potential power of

brands to soften the negative consequences of broader environmental shifts (i.e., systematic rather than firm-specific effects). Notably, studies considering the role of marketing assets in protecting the firm and investors from systematic equity risk have led to diverging findings. While Rego, Billet, and Morgan (2009) find that strong brands can protect the firm from downside systematic equity risk, Bharadwaj, Tuli, and Bonfrer (2011) conclude instead that gains in brand quality may increase systematic risk. While restricted to the firm's economic environment, these studies are evidence that brands can alter the firm's exposure to market-wide environmental shifts, for better or worse. In this paper, we examine the impact of a different environment's systematic shift on firms' marketing performance—the introduction of the Sarbanes-Oxley Act in the United States in 2002—highlighting how this type of systematic shock impacts the firm's marketing efficiency.

It is difficult to overstate the impact of the environment on the firm. First, the firm's ability to adapt and respond to its external environment has been considered as equivalent to the process of strategic management itself (Chakravarthy 1982). Second, depending on the theoretical perspective, the environment has been said to either influence or totally determine firm conduct (Hunt and Morgan 1995). In this context, Hunt and Morgan (1995, p. 12) emphasize that "a firm's comparative advantage in resources can be neutralized by the actions of consumers, government, or competitors . . . governmental action can destroy the value-creating potential of a resource through law or regulation." Ironically, legislative change is the environmental change factor most likely to be met with minimal resistance from managers—and thus result in the fastest behavioral adjustment (DiMaggio and Powell 1983; Scott 1997). Given the frictionless, systemic (rather than targeted), and potentially negative nature of governmental action, as well as the general importance of environmental factors for firm conduct, our review leads us to consider the following question: Can a strong brand buffer the firm from negative consequences arising from government-driven environmental change?

In this paper, we aim to answer this question by showing that (1) governmental action through new legislation elicits a rapid and homogeneous response from firms as they comply and adjust strategy to a new environmental incentive/cost structure; (2) from a marketing perspective, this homogeneity in competitive responses leads to a systemic decrease in marketing efficiency; and (3) stronger brands existing prior to this environmental shift help buffer companies from this loss in efficiency. Specifically, we examine how the introduction of the 2002 Sarbanes-Oxley Act (SOX) and the associated effects on firms' costs and incentive structures led to a shift in the relative emphasis that firms place on two critical marketing activities: value creation (e.g., developing and delivering new products) and value appropriation (e.g., extracting profits from

existing products). Consistent with existing evidence in the finance and accounting literatures that SOX has diminished risk-taking within firms, we hypothesize and then identify a shift away from riskier investments in value-creating activities and toward less risky value appropriation. In light of this shift, we predict—and show—that firms experienced a decrease in marketing efficiency in response to this systemic incentive to engage in value appropriation activities. Finally, we provide evidence demonstrating that previous marketing investments in brand equity undertaken by the firm can help protect it from this negative consequence.

We begin with a discussion of SOX and related research that finds decreased risk-taking in US firms resulting from this legislation, followed by an examination of the resulting resource allocation decision in which firms engaged (made evident by shifts in their strategic emphasis trajectories). We then introduce our methodology for this study, taking advantage of a naturally occurring quasi-experimental interrupted time series empirical design (Nunnally 1960), with the introduction of SOX serving as our "treatment." Finally, we present our results followed by a discussion of their implications for marketing.