

Using Fair-Value Accounting, Fairly

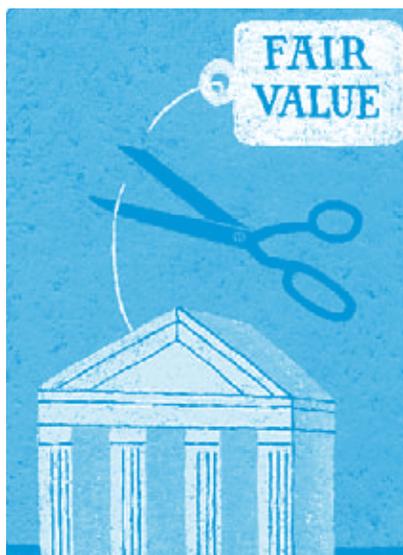
A new market-based approach to calculating the worth of a firm and its assets is gaining ground in financial circles, but it may not make sense for all industries.

As the U.S. savings and loan crisis that rocked the financial and real estate markets some 15 years ago came to an end, accountants strove to understand just what had gone wrong. A key problem, many experts suggested, lay with the methods used to value assets and liabilities on balance sheets.

At the time, the dominant valuation approach was *historical-cost accounting*. This method reports the original amount paid or received for assets and liabilities on a company's balance sheet, as well as earnings generated by the assets and liabilities on the income statement. Banks and savings and loan institutions used historical-cost accounting to report the value of loans and core deposits on their balance sheets, and equity analysts valued these firms from their earnings.

But historical costs are not current values; if interest rates change, the value of deposits and loans also change, and these changes forecast the firm's ability to generate earnings. Just as declines in the market value of mortgages in today's subprime mortgage market indicate potential investment losses, so too the change in the value of loans relative to deposits of savings and loans 15 years ago would have indicated losses. While those losses eventually would have been reported in earnings, market values sound the distress signal a little earlier.

In light of the savings and loan failures, many experts argued for a switch to *fair-value accounting*—marking assets and liabilities on the balance sheet to their market value. Regulators, including the U.S. Financial Accounting Standards Board and the International Accounting Standards



Board, are moving steadily in this direction. Fair value is defined by these bodies as the price at which a firm could sell an asset (or the price it would have to pay to be relieved of a liability).

However, many companies—including retail banks—may be more difficult to value if pushed to comply with the fair-value approach, say Professors **Doron Nissim** and **Stephen Penman** in a new white paper.

“We need to be careful about the application of fair value,” Penman cautions, noting that the accounting shift is arguably the most important and controversial issue facing regulators and accounting standard-setters today. “Fair value is appropriate for a bank’s trading book—the assets and liabilities like shares and bonds whose values depend directly on the change in their market price—but is not appropriate for valuing the banking book, the part of a

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bank that deals with customer transactions such as collecting deposits and making loans,” Penman says. How effective a bank is at delivering its products to depositors and borrowers determines the value of the assets and liabilities in the banking book. Accordingly, the value of those assets and liabilities to the bank may be quite different from what they can be sold for on the market. Further, because active markets do not exist for most bank loans and deposits, accountants have to estimate their value. Estimates can introduce errors and, worse, invite abuse, Penman notes.

the prices paid for coal and other inputs, and thus make a profit.

Accordingly, fair-value accounting that marks assets to market has its limitations for businesses that get value from trading with customers. For these companies, the notion of top-line revenues takes the fore; value is best determined by examining earnings that measure the value added from trading with those customers.

So when does it make sense to use fair-value accounting? In the white paper, Nissim and Penman lay out some principles about circumstances under which fair-value accounting makes sense.

and liabilities were not available, as is often the case. Estimates are made using valuation models—thus the term *marking to model* rather than *marking to market*. So a *no-arbitrage estimation principle* says that the valuation models employed must be so-called no-arbitrage models. This means that the price estimated by the model must not imply that the firm makes an immediate profit against another observed price.

The Black-Scholes option pricing model, which assumes no arbitrage between the option price and the price of the underlying shares, has this feature. So, if the firm estimates the price of a stock option using the Black-Scholes model, there is no implication that the firm can sell the option at the estimated price and buy the stock to make a profit: the option price is a fair one given the price of the underlying stock. The same is not true for a discounted-cash-flow model, which involves arbitrage of current and future input

and output prices—the firm is in the business of buying inputs at one price and selling products later at a higher price, thus arbitraging input and output prices to make a profit.

The no-arbitrage estimation principle disciplines the marking-to-model practice, which has been of particular concern to many who question fair-value accounting.

“Historical-cost accounting is far from perfect,” Penman concedes. “But we must be careful in moving to fair-value accounting as a remedy. Focus on better historical-cost accounting may be an alternative way for accounting standard-setters to go.”

Read More

Nissim, Doron, and Stephen Penman. “Principles for the Application of Fair-Value Accounting.” White Paper No. 2, Center for Excellence in Accounting and Security Analysis, Columbia Business School, 2008.

Doron Nissim is professor of accounting and chair of the Accounting Division and **Stephen Penman** is the George O. May Professor of Accounting and codirector of the Center for Excellence in Accounting and Security Analysis (CEASA) at Columbia Business School.

“**FOCUS** on better historical-cost accounting may be an alternative way for accounting standard-setters to go.”

“The problems that arise in applying fair-value accounting to financial institutions are magnified when it comes to industrial and technology firms,” Penman says. “The value of a pile of coal to a steel producer, for example, comes from its use in making steel, not from what the firm can sell the coal for. Just as bank deposits derive their value as part of a business that makes money from customers, so too with the assets of industrial firms, but these firms have many more assets that do not lend themselves to fair-value accounting. Fair value is often informative, but it does not serve as a panacea for accounting.”

Nissim and Penman argue that value comes, not from the stand-alone market prices of individual assets, but from combining assets under a business model, like using coal, raw iron and smelters together to produce steel. Value is in the entrepreneurial idea, not the market value of the individual assets employed to execute the idea. Indeed, rather than seeing value in market prices, businesses arbitrage market prices to add value—selling products at prices higher than input prices—such as selling steel at a price that is higher than

Foremost is a *one-to-one principle*: fair value is appropriate when shareholder value varies directly with the market price. That is the case with shares and bonds held in a bank’s trading book: if the price of a share held by the bank goes up by a dollar, so does the value of the bank. That is also the case with a hedge fund that holds investments whose value changes with their market price.

Appropriate fair-value accounting also honors a *matching principle*: assets can be marked to market only if associated liabilities are also marked to market. If this principle is honored, the resulting gains and losses are matched with the offsetting gains and losses on the liabilities. So, the debt of a firm can be marked to market when credit quality (and thus price) declines only if the associated assets (whose decline in value resulted in the deterioration of the debt) are also marked to market. In this way the gain from the change in the market price of the debt is offset by the loss from the drop in the value of the assets.

An estimate of market value would be required if market prices for those assets

When Expertise Isn't Enough

Experts may boast intimate knowledge about the specific details of a new product, but that is not always what consumers want.

When deciding to purchase a new product or service, many consumers do their homework, diligently researching options and gathering information from several sources. While common sense says we are likely to consult an expert for details about a particular item, who we turn to for product advice is actually based on a combination of factors, says Professor **Donald Lehmann**.

Lehmann and coresearchers Jacob Goldenberg, Daniela Shidlovski and Michal Master Barak of the Hebrew University of Jerusalem were interested in finding out who is more appealing as an information source: experts, who have knowledge about technical information such as product features and attributes, or social connectors, who gather, from a large circle of acquaintances, information about product problems and usage experiences.

The researchers conducted a series of studies in which subjects received descriptions of either a radically or incrementally new product to purchase for their jobs—for example, a keyboard that recognizes finger movement and transfers the movements into letters (radical) or a wave-shaped keyboard that enables faster typing (incremental). Subjects also received descriptions of a social connector and an expert they could confer with about the purchase and were asked to rate how much they wanted to consult each adviser and how helpful they expected that advice to be.

Contrary to the researchers' expectations, subjects often preferred to consult with social connectors over experts. While experts may have superior knowledge, they don't always understand the problems everyday users face and may not speak a language laypeople can understand. "It is natural to want to talk to an expert about a new product or service," Lehmann says. "If you require surgery, for instance, you want to see the top surgeon in the field, right? But the surgeon is not as good as a patient or someone who knows people who



have had the surgery at explaining what your experience will really be like."

The researchers also found that subjects' preference for an expert or a social connector changed depending on the level of innovation of both the product and the consumer seeking advice.

For less innovative products—an update of an existing product, for instance—people were more likely to seek information from an expert than from a social connector. Because consumers already possess a basic understanding of the product, Lehmann explains, the additional information a social connector can offer will not be sufficient; they need details only an expert can provide.

Innovative consumers (early adopters who enjoy trying new products) consistently turned to experts for advice, regardless of the type of product they were considering or the type of information they were seeking, the researchers found. By contrast, noninnovators (consumers who are more concerned about how easily they can use a new product than what its most advanced features are) preferred to consult

with social connectors for radically new products but with experts for incrementally new products.

Noninnovators also changed their preferred advice sources depending on the type of information they sought. "A novice or noninnovative person wants to speak with a social connector about procedural issues, but they prefer talk to an expert about more technical details," Lehmann says. Social connectors, he explains, can supply feedback from other users who, for instance, have learned to operate the touch pad on an iPhone; but for more complex tasks like transferring music files to the phone from a computer, even a noninnovator will need an expert because

that task is likely beyond the scope of a social connector's understanding.

Why explore these differences? In today's Internet-driven society where constant access to a plethora of information is the norm, companies can benefit by determining who consumers depend upon when researching product decisions. "If a company trying to sell a new product knows where people seek advice and information about the product," Lehmann says, "it can intervene in the process and raise its chances of success."

Read More

Goldenberg, Jacob, Donald R. Lehmann, Daniela Shidlovski and Michal Master Barak. "Preference for New Product Information Sources." Working paper, Columbia Business School, 2007.

Donald R. Lehmann is the George E. Warren Professor of Business in the Marketing Division at Columbia Business School.

Found Your Dream Car? Thank the Competition

Whether consumers find the car of their choice in stock is directly related to the competitiveness of their local auto market.

Driving off the lot in a shiny new car, an auto buyer is not likely to spend much time thinking about how the car company's dealership network structure and inventory strategies affected the purchase. A dealer's inventory levels *will* be a primary concern, however, if the buyer's first choice of vehicle is not available, meaning the buyer has to wait longer to get the vehicle, choose a replacement car or leave without making a purchase.

For auto manufacturers and their dealers, dealership network configuration and inventory strategies are crucial to business success. The number of dealerships carmakers operate, the market conditions where those dealerships are located and the inventory dealers keep on hand can mean the difference between closing a sale and losing the buyer to a rival dealership or a different carmaker.

Professor **Marcelo Olivares** recently studied this interplay between competition and inventory in U.S. auto dealerships and, with Gerard Cachon of the University of Pennsylvania, developed an econometric

researchers monitored when a vehicle was added to or removed from a dealer's inventory, as well as when a car was transferred from one dealer to another. They focused on GM dealerships in markets with 5,000 to 120,000 residents, which made it easier to accurately measure competition.

After analyzing the GM dealership data on such dimensions as sales volume, market competition and local consumer demographics, the researchers found that competition had two main effects on inventory holdings: First, the entry or exit of a competitor in a market—either another GM dealer or a dealer for a rival car company—can increase or decrease demand (a sales effect); second, it can change the amount of buffer inventory a dealer chooses to hold, which influences the probability that customers will find the cars they desire in stock (a service effect).

Olivares and Cachon were particularly interested in exploring the service effect. "If you double sales, your inventory cost per unit sold is going to go down; this is very well known. But service matters too,"

Olivares says. Indeed, one of the researchers' key findings was that with fewer competitors—some of the markets they studied had only one or two dealerships—

dealers could set lower inventory levels without losing sales. In these smaller markets, dealers did not need to not have a diverse inventory, because they were not competing with many rivals. "When there is more competition, customers have more choices, and when they have more choices, they become pickier. Dealerships raise their service levels when they face more intense competition to prevent losing customers," Olivares notes.

But the presence or absence of a competitor alone does not explain the whole

inventory picture. The impact of competition on inventory holdings, and thus on service levels, also depends on the number and types of products area dealers offer. "If a competitor offers models that are similar to the products offered by another dealer, it will trigger a larger increase in service level," Olivares says. For example, a GM dealer is more likely to hold a large inventory of its entry-level SUV if a neighboring Jeep dealer also offers a low-priced SUV. This strategy can help the GM dealer prevent a customer from driving away in a Jeep.

Ultimately, dealerships must strike an optimal inventory balance to remain competitive. "You don't want to have too little inventory, because then you don't have enough variety for customers to get the car they want," Olivares says. "But if you have a lot full of cars, you are spending fixed capital, you're not turning inventory quickly and your profitability goes down."

Read More

Olivares, Marcelo, and Gerard P. Cachon. "Competing Retailers and Inventory: An Empirical Investigation of U.S. Automobile Dealerships." Working paper, 2007.

Olivares, Marcelo, and Gerard P. Cachon. "Drivers of Finished Goods Inventory in the U.S. Automobile Industry." Working paper, Columbia Business School, 2008.

Marcelo Olivares is assistant professor of decision, risk and operations at Columbia Business School.

THE PRESENCE or absence of a competitor alone does not explain the whole inventory picture.

model to estimate the effect of market structure on inventory holdings. "Our main objective," Olivares explains, "was to provide a tool to analyze the efficiency of auto distribution networks."

The researchers culled data from a General Motors (GM) Web site that lets customers search new-vehicle inventory at local dealerships. Olivares and Cachon created a Web crawler to monitor the site daily, and they collected six months' worth of inventory and sales data from GM dealerships in more than 200 rural markets. The

Building Better Market Research

A new method for designing market-research experiments reduces costs and yields more precise results.

What do customers want? Firms spend millions of dollars on market research trying to answer that question. Market-research experiments traditionally have employed conjoint analysis, a method that relies on statistics and psychology, to estimate the importance of specific product features and to ask such questions as which would a customer value more, having a wider TV screen or saving \$500?

The problem with this approach is that firms almost always need to know how customers value different combinations of features, rather than simply to understand the absolute value derived from each feature. “A company wants to know whether a customer values HDTV [high-definition television] more than a large screen,” Professor **Olivier Toubia** explains. “Would a customer pay more for HDTV even if the size of the screen isn’t bigger than their old TV? It’s not the features per se they are interested in, it’s the relative value of each.”

Toubia and John Hauser of the Massachusetts Institute of Technology wanted to design experiments that produced better results, which could help market researchers and their clients address the limitations of standard conjoint analysis. “Some decisions and combinations are more critical than others,” Toubia says. “If you just apply standard market-research methods, you may get precise estimates of preferences for features, but estimates for the combinations of those features will not be as precise.”

The researchers created a theoretical model and ran simulations showing that experiments designed to look at product features in different combinations would produce more precise estimates of consumers’ preferences than those looking at each individual feature as its own distinct parameter. The method included additional criteria for measuring managerial efficiency, taking into account that certain managerial decisions about how to market



a product are weighted differently. For example, it may be more important to a marketing department to identify a tactic that can be executed quickly than one that is cheap to implement.

Toubia and Hauser’s results suggest that efficiency increases of up to 30 percent are possible. Modest improvements in the efficiency of experiments can yield dramatic reductions in the cost of conducting market research. “In the pharmaceutical industry, you sometimes have to screen 50 people to get one respondent, and the cost is high—about \$450 per person,” Toubia says. “If you cut the number of people you need to survey in order to get reasonable estimates, you save a lot of money.”

Because their method considers the different decisions marketing managers will need to make, Toubia and Hauser’s work might also help market-research firms to tailor experiments more precisely to the goals of their clients and to consider how the results of each experiment will be used, a practice that is not the norm in the field.

“Experiments are typically designed without consideration of the end goal.

But the end goal should be taken into account in the design phase. Are some criteria more important than others? Are some combinations more important than others? The more critical features should receive more extensive attention than others,” Toubia stresses. “How you intend to use the results will inform how you are going to design the experiment.”

The researchers hope that their work will change the way market research is conducted. Until their method is adopted broadly, Toubia says that any firm hiring a market-research consultant should make sure the consultant will tailor the service to the firm’s needs. “Market-research consultants should ask how a firm will use the results of a study before they design

it,” Toubia says, “as opposed to using some off-the-shelf approach that doesn’t take into account the context behind why the firm is undertaking the research.”

Read More

Toubia, Olivier, and John R. Hauser. “On Managerially Efficient Experimental Designs.” *Marketing Science* 26, no. 6 (2006): 851–58.

Olivier Toubia is the David W. Zalaznick Associate Professor of Business in the Marketing Division at Columbia Business School.

RESEARCH BRIEF

Topics: Media and Technology, Operations, Organizations

THE IDEA

Finding the optimal level of task specialization helps organizations adapt and gives workers needed flexibility.

THE RESEARCH

In stark contrast to the assembly lines of the past—where homogeneous products were the norm—modern production lines produce highly specialized goods. Many economists have argued that advanced communication technology is responsible for a different but related shift toward task specialization. The ability to call, e-mail or connect online with other employees is presumed to eliminate time and space boundaries and allow companies to better coordinate specialized production tasks. But a growing body of research shows that companies today are actually giving workers less specialized tasks, suggesting that improved communication technology does not necessarily translate into increased levels of specialization.

According to Professor **Tano Santos** and Wouter Dessein of the University of Chicago, improved communication does allow organizations to capitalize on specialization—but only to a point. Once the number of people who are using new communication tools exceeds a certain level, the volume of new information shared between specialists becomes difficult to manage, with diminishing returns. To better coordinate specialized tasks, organizations are embracing a bundling approach—assigning more tasks to each person—which gives workers more flexibility in carrying out their work and improves efficiency, since valuable information can be applied to several tasks at once.

Santos and Dessein developed a mathematical model in which many workers carry out many tasks. In the model, productivity depends on how an organization adapts to *local information*—information in the work environment that pertains exclusively to one task and can be observed only by the worker carrying out that task—and how well it coordinates various tasks across teams. By analyzing the number of tasks each worker performed as conditions changed, the researchers determined that the division of labor decreased as uncertainty in the work environment grew, resulting in more flexibility and task bundling. In addition, they found a threshold at which an increase in specialization resulted in a decrease in productivity.

Striking the right balance between adaptation and specialization, then, can maximize worker productivity without requiring unreasonable levels of coordination. To increase productivity, the researchers suggest, organizations should assign more tasks to each worker, as long as workers can efficiently adapt and coordinate tasks. This approach enables organizations to adapt tasks rapidly to accommodate shifting market or operational conditions.

AN ORGANIZATION'S productivity depends on how it adapts to *local information*—information that can be observed only by the worker carrying out a particular task.

PRACTICAL APPLICATIONS

Marketing managers, human resources managers

This research can help you determine the optimal tradeoff between task specialization and adaptation for employees. If you work in an industry that must respond to fickle, fast-changing consumer tastes, such as apparel manufacturing and software development, you may find this research especially useful.

Read More

Santos, Tano, and Wouter Dessein. “Adaptive Organizations.” *Journal of Political Economy* 5 (October 2006): 956–95.

Tano Santos is professor of finance and economics at Columbia Business School.

RESEARCH BRIEF

Topics: Capital Markets and Investments, Marketing, Strategy

THE IDEA

Perceptions of brand relevance and energy can influence a firm's accounting performance and stock price.

THE RESEARCH

For years, accountants have struggled to determine the value of brands because of the intangible nature of brand attributes. How much would a competitor pay for the McDonald's golden arches or Coca-Cola's logo to gain these iconic images' power to create and sustain customer loyalty? And what price can be put on an underdog brand that rebounds, such as Apple? Do consumer perceptions of a brand actually influence how investors value a firm?

Such questions prompted Professor **Natalie Mizik** and Robert Jacobson of the University of Washington to look for a possible link between perceptual brand attributes (perceived brand differentiation, relevance, esteem, knowledge and energy), accounting performance and share price. Based on their findings, the researchers suggest, marketing departments may want to rethink which brand attributes they spend money on.

The researchers examined Young & Rubicam's Brand Asset Valuator database—a collection of 56 attributes associated with major corporate brands, culled from surveys conducted between 1993 and 2004—to assess the financial value of consumer brand perceptions. They tested the five perceptual attributes against the share prices of 275 monobrand (companies with one brand representing the bulk of their business). Their list of monobrand included IBM, Starbucks, Reebok, Krispy Kreme and AOL. To control for the impact of accounting performance on stock price, Mizik and Jacobson factored in earnings data from Compustat files.

Their study shows that the perceived brand relevance (a palpable link between the company and consumer) and energy (innovativeness and dynamism) associated with a particular brand may influence a firm's stock price. In other words, relevance and energy combined with accounting-performance information explain stock returns significantly better than accounting-performance information alone. Perceived brand differentiation, esteem and knowledge did not show an impact incremental to current earnings. The financial impact of these brand attributes is fully reflected in current earnings.



PRACTICAL APPLICATIONS

Marketing and investor-relations specialists, financial experts

Identifying the perceptual brand elements that influence corporate valuation can help you make tough budget decisions, focus advertising campaigns and design better brand-building strategies; understanding how brand relevance and energy impact stock returns may inspire you to articulate brand strategy more clearly to investors. You may also find this research useful in preparing for a takeover, public offering or spin-off.

Read More

Mizik, Natalie, and Robert Jacobson. "The Financial Value Impact of Perceptual Brand Attributes." *Journal of Marketing Research* 45, no. 1 (February 2008): 15–32.

Natalie Mizik is the Gantcher Associate Professor of Business in the Marketing Division at Columbia Business School.

Pricing for Profitability

Multipart pricing schemes that factor in consumer behavior and consumption rates can help companies boost profits.

Selecting a cell-phone plan today involves many decisions: Pick a plan with a low monthly rate or one that offers more minutes? Add text messaging? Opt for rollover minutes? This array of choices comes from the increasing popularity of a method for building service plans known as multipart pricing.

In contrast with traditional flat-rate plans (\$75 a month for a gym membership, for example), multipart pricing schemes include a fixed fee for a specific duration, a usage allowance, a variable fee for use beyond the base level and additional charges for add-on services—for example, the familiar cell phone plan charging \$40 per month for 400 minutes, \$0.20 per minute thereafter and \$5 to add voice mail. Businesses such as cell-phone providers, HMOs and car-rental firms, among many others, have embraced multipart pricing because it allows them to tailor prices to target specific consumer segments and has been shown to boost profitability.

Consumers have responded positively to multipart pricing because it lets them choose the option that most closely meets their needs. Frequent cell-phone users, for example, are likely to select a plan with a lot of minutes, while infrequent users can opt for a cheaper plan offering fewer minutes. Many companies, however, fail to factor in these consumption rates when developing their multipart pricing schemes and, as a result, offer plans that are suboptimal, Professor **Kamel Jedidi** says. “In deciding what plans to offer, a company has to properly measure how consumers react to changes in fixed fees, usage allowances and marginal prices as well as how these changes affect consumption,” he explains.

To help companies do just that, Jedidi worked with Professor **Rajeev Kohli** and Raghuram Iyengar of the University of Pennsylvania to develop an improved model for generating multipart pricing

schemes. Their model, Jedidi says, allows companies to estimate the market share and usage of a service or a product, identify the best pricing plan for maximizing profit and calculate optimal prices for add-on features. “The novelty in our approach,” Jedidi explains, “is understanding that the plan’s benefits arise not only from its features but also from the consumer’s expected consumption under this plan.”

THE KEY is to understand the value that customers attribute to each service feature.

The key to devising optimal multipart pricing schemes is to understand the value that individual consumers attribute to each service feature, rather than simply looking at the service as a whole. When choosing among plans, Jedidi notes, consumers weigh the benefits and costs of each plan by analyzing each aspect of the plan.

Jedidi, Kohli and Iyengar developed their model using data from a study that asked subjects to select the best hypothetical cell-phone service plan from a variety of options, based on a number of different attributes. The researchers then compared the multipart pricing plans built using their model against those built using six other models and found theirs to be a better predictor of consumer demand. “Being able to predict demand volume under different pricing schemes,” Jedidi says, “is exactly what is needed to bring optimal multipart pricing schemes to market.”

The researchers’ model also offers insights about how consumers respond to changes in prices and plan-usage allowances. For example, the researchers found that reducing the monthly fee did not affect the number of minutes customers used if they normally used fewer minutes than the monthly plan allowed. Similarly,

increasing the number of free minutes allowed by a plan did not change how many minutes customers actually used if their normal consumption rate was below the plan’s limits. By contrast, existing multipart pricing models incorrectly predict that lower prices or higher usage allowances are always associated with higher consumption.

This new model can help companies improve what is already an effective strategy. By accurately targeting the needs of a wide range of users, companies using multipart pricing plans can increase profitability and stimulate demand. In addition,

these plans can help firms retain customers for a certain period. “Once customers pay the plan’s fixed fee, they are unlikely to switch to a competitor, because they would have to pay the fixed fee again,” Jedidi explains. “Multipart pricing has the added advantage of locking customers in for a while.”

Read More

Iyengar, Raghuram, Kamel Jedidi and Rajeev Kohli. “A Conjoint Approach to Multipart Pricing.” *Journal of Marketing Research* (forthcoming).

Kamel Jedidi is professor of marketing and chair of the Marketing Division and **Rajeev Kohli** is professor of marketing at Columbia Business School.

Deal or No Deal: Should Economy Airlines Offer Last-Minute Bargains?

Offering last-minute deals is not always a sound pricing tactic for airlines, but under some circumstances, economy carriers may want to offer such bargains.

Economy airlines often prosper in the airline industry because they buck traditional pricing and revenue-management strategies. Launched in 1995, easyJet is one of the most successful of the new economy carriers in Europe. Unlike many of its larger European counterparts, easyJet offers a single class of seat at one price and does not offer last-minute deals. Customers are assured that it's in their best interest to buy a ticket now instead of later, and easyJet typically enjoys a steady stream of passengers, with no need to direct resources to expensive, complicated pricing and revenue-management systems.

Professor **Oded Koenigsberg** wanted to know if this single-price policy was the optimal pricing strategy for easyJet and similar economy carriers, and to determine whether easyJet could build on its success by offering last-minute deals. To answer these questions, Koenigsberg and coresearchers Eitan Muller of New York University and Naufel Vilcassim of London Business School examined pricing and demand patterns for easyJet flights in six pairs of European cities.

The equation for setting the price of a ticket is complex in the airline industry. Customer demand can rise and fall quickly over weeks or days, but carriers' ability to expand or scale back their service is very inflexible. If an airline misjudges growth, it can find itself with too few seats, unable to take advantage of increased demand and losing out on revenue. Or if a carrier has overestimated how many seats it can fill on a regular basis, it may find itself strapped for cash. Carriers also can't be sure of their competitors' seating capacity, further complicating the pricing challenge.

Then there's the question of offering last-minute bargains on unsold seats. In the 1970s, major carriers started to offer last-minute deals, releasing remaining seats on underbooked flights. U.S. carriers all but did away with last-minute deals in



the 1990s, but most European airlines still offer last-minute deals on the rationale that it's better to fly a fuller plane than leave seats empty. But price-conscious customers with flexible travel dates will wait for last-minute deals in lieu of buying a more expensive ticket early in the selling cycle. "The caveat is that consumers may start to expect lower prices and delay their purchases," Koenigsberg explains. "That puts more pressure on airlines to lower fares." Economy carriers have resisted offering last-minute deals.

Koenigsberg and his coresearchers found that easyJet's seating capacity rests between the extremes of high and low and that hitting a sweet spot of intermediate seating capacity means the single-price strategy is the optimal policy for the airline. However, the researchers also found that easyJet could benefit by randomly offering last-minute deals under its single price strategy. By only occasionally lowering

ticket prices to bump up revenue on some underbooked flights, easyJet could avoid creating the expectation that such bargains would be available on a predictable basis.

Koenigsberg's assessment of easyJet's pricing strategy has prompted him to wonder if other airlines might rethink how—or even whether—they should offer last-minute deals. By scrambling to fill all seats on all flights for the sake of short-term revenue, carriers may be losing out in the long term. "Airlines should reconsider how they offer last-minute deals," he says. "If customers know a firm is likely to reduce

prices if demand isn't strong, many of them will put off buying tickets, waiting for the price to go down. In many cases it is better for airlines to fly with empty seats than to reduce prices."

Read More

Koenigsberg, Oded, Eitan Muller and Naufel J. Vilcassim. "easyJet® Pricing Strategy: Should Low-Fare Airlines Offer Last-Minute Deals?" *Quantitative Marketing and Economics* (forthcoming).

Oded Koenigsberg is associate professor of marketing at Columbia Business School.



Who's Afraid of Sovereign Funds?

David Beim discusses why America has little to fear from opening its markets and much to gain from putting its fiscal house in order.

During the past 10 years America has become uncharacteristically fearful: fearful of other countries, fearful of terrorists, fearful of immigrants, fearful of foreign trade. The latest subject to provoke shivers of anxiety is the rise of sovereign wealth funds, notably the investment by a number of the funds last year of nearly \$20 billion in several leading U.S. financial institutions. These funds represent current account surpluses accumulated by other countries over the past decade and are the counterpart to America's escalating current account deficits in the same period. The funds now total about \$3 trillion but went unnoticed by the general public until they started bailing out major financial institutions.

For example, Singapore's fund bought a 9.4 percent stake in Merrill Lynch for \$4.4 billion, one Chinese fund bought \$5.6 billion of securities convertible into 9.9 percent of Morgan Stanley, Abu Dhabi's fund put \$7.5 billion into a 4.9 percent stake in Citigroup and another Chinese fund invested \$1 billion of equity in Bear Stearns (later aborted).

Worried commentators such as former U.S. Treasury secretary Lawrence Summers, Sebastian Mallaby of the Council on Foreign Relations and Edwin M. Truman of the Peterson Institute for International Economics point out that government funds are inescapably political; they are not just passive investments but means for countries to extend their influence over world events. America must be at risk, they say—what will these investors do, what do they want and will they ever go away? Such commentaries often end with calls for regulation of U.S. investments by sovereign funds or for standards of transparency by such funds.

I find it hard to share these anxieties. To me sovereign funds are just another aspect of globalization. Our largest financial institutions are no longer exclusively “ours” but have become part of the global economy. Opening our borders to flows of goods, services and investment capital has brought many benefits and has internationalized most large business organizations, which have learned how to balance needs and challenges from all sides. America has long extended its investment capital into other countries, and we need to get used to other countries doing the same.

How did the sovereign wealth funds get so large so quickly? The answer is not difficult to see: America has imported dramatically more than it has exported in recent years. Because governments run the foreign-exchange markets in countries such as China, the United Arab Emirates and Singapore, governments tend to collect the dollars that Americans pay for excess imports. As U.S. current account deficits have continued unabated, the sovereign funds have grown rapidly. In the past these dollars were put into passive investments such as government bonds and bank deposits. But the fund managers are diversifying and, in particular, are seeking returns higher than those available on bonds and bank deposits. Equity investments are as attractive to these countries as they are to us.

These funds' recent investments were a benefit to both sides. The financial institutions got large capital infusions they badly needed after the recent wave of credit losses left their equity seriously depleted. If Merrill Lynch, Morgan Stanley and the others had sold stock to U.S. investors in public offerings, the stock prices would have been brutalized. For example, Société Générale recently suffered an

astonishing \$7 billion loss but declined to replace the capital by going to a sovereign wealth fund. Instead, it announced a rights offering at a 39 percent discount below its February 8 closing stock price, which had already been knocked down to a three-year low. Similarly, the sovereign funds had a golden opportunity to acquire major blocks of stock in leading institutions without disturbing the public market.

The funds are acting carefully, limiting their future actions. They have expressed no interest in joining the boards of the firms they have invested in. The transactions involve standstill agreements that limit the funds' ability to expand their positions in these companies. To be sure, large shareholders can exert some influence over management, but their voice will be only one among many. Modern companies have learned how to handle many stakeholders.

I do have some concerns at the macroeconomic level. I see little to fear in the recent transactions taken on their own, but the broader pattern of trading assets for goods is unsustainable in the long run. We have a finite number of investment assets to sell but an apparently infinite appetite for cheap foreign goods. America used to be a fountain of capital to the rest of the world. Now it has become the world's largest debtor.

I believe we need to moderate our appetite. If we do not, the foreign-exchange markets are likely to drive the dollar ever lower, making our imports ever more expensive until balance is restored. Our huge deficits are enriching the developing world—with an efficiency that foreign aid could never have accomplished—and punishing our currency. There is much we can do to mitigate the global financial imbalance.

We can start with oil. If we could double the fuel efficiency of our automobiles, the effect on oil imports would be dramatic. We also need to rein in our foreign military adventures. Apart from their negative impact on America's reputation in the world, they are terribly expensive. In fact, if the U.S. government could get its fiscal budget under control, that too would make

some contribution to correcting the external trade imbalance.

So I suggest we get over our fears of sovereign wealth funds and concentrate our minds on issues that truly will make a difference to America's future.

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This piece originally appeared on Public Offering, the Columbia Business School blog. To comment on this piece or to read other posts, visit www.gsb.columbia.edu/publicoffering.

Hard Choices Made Easy

Categorizing similar products can make choosing easier for undecided shoppers—even when the options aren't so different.

Professor **Sheena Iyengar's** research has frequently considered the difficulties people face when they have too many choices, producing the insight that, sometimes, too many choices can lead to less, not more, happiness. It was an insight that naturally led Iyengar to wonder if there was a way to make choosing from among many options less overwhelming.

Consider a person who visits the neighborhood bookstore to buy a book about lawn care. Such a customer has only the simple task of choosing one book from the store's array of lawn-care books. "If it's just a preference-matching task, the

But when the same customer returns to the bookstore to find a good read for an upcoming vacation but without any specific book in mind, a more complicated task is at hand. As a *preference constructor*, the customer will need to narrow down a great number of possibilities to just one book.

In weighing the differences between preference matchers and preference constructors, Iyengar wondered if categorizing available options was one way to make choosing from many options more accessible. Research in linguistics and psychology has shown that putting any

from a bag of rice displayed in the grains and cereals aisle.

Iyengar also wanted to learn whether people would end up happier with the choices they made if choosing was made easier. Marketers have long understood that people infer meaning from information that is essentially meaningless. In a scene from the TV show *Mad Men*, an advertising firm pitches the idea of renaming a bank's existing account service "private executive accounts," and its enthusiastic clients immediately understand that by tacking on the essentially meaningless phrase "private executive" they could create a sense of innovation in an old product.

Based on that understanding, Iyengar proposed the *mere categorization* hypothesis: that nothing more than placing options in categories—even when the choices are in fact the

same—might help consumers negotiate options and derive more satisfaction from the choices they make.

To test her hypothesis, Iyengar, working with research assistant Tamar Rudnick and PhD candidate Cassie Mogilner of Stanford

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WHY is it important for consumers to feel they have a bigger variety of options than they really do?

number of choices shouldn't bother you in the least. It might take you a little longer, but you can scan your options and see it, and you can stop," Iyengar explains. A *preference matcher* is simply eliminating options that don't measure up to the choice already in mind, so there's little struggle about the decision at hand.

given thing into a category causes people to perceive differentiation. People tend to assume that an item placed in one category is different from an item placed in another category—for example, a bag of rice displayed in the ethnic foods aisle of a grocery store is presumed to be different



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University, first conducted an experiment using magazines. More than 100 different magazines were displayed in magazine racks, including titles both familiar and unfamiliar to the experiment’s subjects. At times the magazines were displayed and labeled in three broad categories, while at other times they were grouped into 18 categories. Iyengar simulated preference-matching behavior by asking some subjects to pick a magazine they read regularly; preference-constructing behavior was examined by asking subjects to pick a magazine they did not regularly read. Subjects then rated both how satisfied they were with their choices and how much variety they perceived.

Preference constructors were much happier with their choices and perceived more variety when they chose from 18 categories than when they chose from only three categories. Preference

matchers, though, did not experience the impressions of variety or satisfaction with their choices to the same degree.

This part of the study confirmed Iyengar’s hypothesis that categorization would lead to greater satisfaction on the part of the buyer, but it also suggested that choosing from more categories, rather than less, would make choosing easier and contribute to satisfaction.

Iyengar then verified another aspect of her hypothesis—that even when identical products are assigned different labels, buyers’ satisfaction is related to what they think they are choosing based on its label, not its actual contents. This second study simulated a coffee

shop at which subjects were sometimes offered coffee menus with no categories but at other times were asked to select from coffee menus that featured informative categories (spicy, nutty or mild, for example), somewhat uninformative categories (using fictitious retailer names such as Coffee Time, The Living Room or The Gathering) or wholly uninformative categories (category A, B, C, etc.). As in the magazine study, to simulate preference matching and preference constructing, some subjects were instructed to choose a flavor familiar to them, and others were instructed to choose a flavor unfamiliar to them. Importantly, while all of the subjects believed that they were choosing from many different options, all were given the same flavor of coffee.

The study’s results seem to confirm that preference constructors require the kind of “help” in decision making that categorization seems to provide and are more satisfied with their choices when they get that kind of help. Preference

constructors were more satisfied with their coffee choices than preference matchers when the choices were categorized; they were less satisfied than preference matchers when they chose from the menus without categories. The preference constructors also perceived more variety when choosing from any of the categorized menus and far less variety when choosing from the menus without categories.

But if, as a growing body of work by Iyengar and others suggests, more choice is not always better, why is it important for consumers to feel that they have a greater variety of options than they really do? If customers—especially those who aren’t immediately sure of what they want—see a greater number of categories, they perceive a greater variety of choice, and typically a domino effect ensues: the greater the perceived variety of choice, the greater the feeling of self-determination; the greater the feeling of self-determination, the happier the customer.

“Categorization does not interfere with preference matchers, and it benefits the preference constructors,” Iyengar explains. “Since marketers don’t know which you are, they’re better off providing some sort of categorization scheme, leaving a larger subset of shoppers happier with their choices.”

Read More

Mogilner, Cassie, Tamar Rudnick and Sheena S. Iyengar. “The Mere Categorization Effect: How the Presence of Categories Increases Choosers’ Perceptions of Assortment Variety and Outcome Satisfaction.” *Journal of Consumer Research* (forthcoming).

Sheena S. Iyengar is professor of management at Columbia Business School.

Matters of Trust Play Out on the Global Stage

Why do Americans and Japanese show different levels of trust?

The answer lies in each culture's approach to building relationships and social networks.

In today's increasingly globalized world, understanding differences in customs, mannerisms and the way relationships are built can make or break international business dealings. For that reason, says Professor **Ko Kuwabara**, it is important to understand how trust develops in exchange relations.

His new research—conducted with Robb Willer of the University of California, Berkeley; Michael Macy of Cornell University; and Rie Mashima, Shigeru Terai and Toshio Yamagishi of Hokkaido University—highlights the role of social networks in explaining the differences in trust levels between Japanese and Americans.

“The popular view is that Japanese society is very high in trust—it is a safe country with low crime, a high level of social order and an emphasis on relational obligations,” Kuwabara says. “This is in contrast with the perception of the United States as an individualistic culture that values self-interest. However, the surprising finding is that if you carefully measure trust in controlled studies, Americans tend to report higher levels of trust in strangers than Japanese.”

What is Kuwabara's explanation for this paradox? “Trust is like a muscle: you use it or you lose it. That is, trust is less likely to develop in societies where people are trustworthy.” In Japan, the cultural value system stresses building durable relationships—for example, lifelong employment with one company was very common until recently, and Japanese people tend to interact with people within denser networks with more limited exposure to outsiders. “The United States, on the other hand, is characterized by higher mobility—people move around and switch jobs a lot more—which requires Americans to develop greater trust in strangers,” Kuwabara says. This implies that Japanese tend to build on existing relationships to sustain trust and that Americans develop trust to explore opportunities for new relationships.

To test their theories on what drives how trusting and trustworthy Japanese and Americans are, the researchers conducted a

variation of the Trust Game. The game is a commonly used research tool in which participants are given money and must decide how much to keep and how much to entrust to another participant who may or may not return the money. For example, players may be given \$50; any portion of it that they decide to keep becomes their personal profit for that round. If they entrust \$20 to another player, the amount is tripled (it's now worth \$60) and given to the receiver, who then decides how much to keep and how much to send back.

The dilemma for the truster is that entrusting money creates a surplus for both parties, but the action is rational only if the receiver returns more than the amount entrusted.

“**TRUST** is like a muscle: you use it or lose it.”

This tension between individual self-interest and the mutual beneficial exchange for both parties, Kuwabara explains, makes this game an ideal way to study how people make trust decisions in a very controlled environment.

In this study, participants played the game on the Internet, which allowed real-time interaction between players from the two countries. Participants could choose with whom to interact, so they could build networks by playing repeatedly with the same players or transact with different players each time.

This ability to build exchange relationships was a key factor behind the central result of the study. The researchers found that the Japanese players were more trustworthy (that is, they were more likely to return the money entrusted to them) than the American players, but that difference was due to the exchange relationships built by the Japanese players.

“The difference in levels of trustworthiness can be explained in terms of the kind of relationships Japanese and Americans players built during the game,” Kuwabara says. “Americans chose to ‘play the field’

and transact with multiple players, while Japanese were more likely to commit to exchanging with fewer people, which reduced untrustworthy behavior within these relationships.” On the other hand, the Japanese players were more likely than Americans to trust and cooperate with their partners, but only to the extent that they were in durable relationships. Outside of these relationships, Kuwabara explains, they were no more trusting or trustworthy than their American counterparts.

The researchers' findings reinforce the widespread perception that Japan is a more collectivistic society with higher levels of trust and prosocial behavior than are found the United States. But more important, the

research points to the way each culture develops social networks as the root of these differences.

“Americans doing business in Japan need to understand the importance of concrete social relations when dealing with Japanese people,” Kuwabara says. “While Americans think of networking as a chance to build their Rolodex, Japanese people use social networks to develop deeper trust within close relationships.”

Read More

Kuwabara, Ko, Robb Willer, Michael Macy, Rie Mashima, Shigeru Terai and Toshio Yamagishi. “Culture, Identity and Structure in Social Exchange: A Web-based Trust Experiment in the United States and Japan.” *Social Psychology Quarterly* 70, no. 4 (2007): 461–79.

Ko Kuwabara is assistant professor of management at Columbia Business School.

The ROI of CSR

Q&A with Geoffrey Heal

Geoffrey Heal discusses his new book *When Principles Pay*, in which he considers how a firm's environmental and social performance affect its competitiveness and financial performance.

Q. Why did you write *When Principles Pay*?

A. There was a lot of interest in the Business and Society course I've been teaching the last few years, but there were no books that covered the material. And in the last five or six years, there has been a growing sense that business schools need to do more to engage their students in considering ethical issues. I saw a need to take a distinct angle on ethical issues, rather than the standard "this is what is right, this is what is wrong" approach.

I wanted to look at ethics in a business context and particularly in light of two aspects of business operations. First is the environmental impact—all businesses have an environmental impact to a greater or lesser degree. The second aspect is social impact, by which I mean a company's impact on minorities, the poor and people in developing countries. I began to focus on how a firm's behavior on those two fronts affects its success in terms of conventional measures: profitability, market valuation, market share, brand value and brand image. In other words, is there a payoff to behaving well?

A. Consumer pressure certainly plays an enormous role. The success of Whole Foods is almost a cliché. The extraordinary growth in the last 10 years of organic food, which is more expensive than regular food, has shown that people are willing to pay a higher price, partly because they think organic food is better for them, and partly because they think it's better for the whole world. People are willing to pay a premium to get things they believe are more environmentally and socially acceptable. The Toyota Prius is now one of the 10 best-selling cars in the United States, overtaking the Ford Explorer in popularity. A car like the Ford Focus, comparable in size and features, is roughly \$5,000 less than a Prius, but people are willing to pay extra for an environmentally low-impact car.

Managing impacts is a way firms reassure consumers that it's legitimate to buy a company's product or that buying the product doesn't conflict with the customer's values. The companies most sensitive to CSR efforts are those for which brand image matters. If a company has a negative image, customers will sometimes



If a tobacco company gives money to the Metropolitan Opera, it may be good philanthropy and it may be good public relations, but it's not CSR because it does not address the social and environmental problems caused by a tobacco company.

— Geoffrey Heal

Did this product damage the environment when it was made? For some customers, buying is a statement of values.

Companies also face pressure from investors to manage their impacts. Socially responsible investing [SRI] has existed for many decades but really took off during the antiapartheid movement in the 1980s. People were trying to persuade big funds to sell their shares in companies that did business with companies in South Africa, which was the first time there was a major effort to use capital markets to influence corporate policy. SRI has grown quite a bit. Today between 10 and 12 percent of the money that is professionally managed in the United States is cast as SRI, having some kind of social or environment goals or limitations on how the funds can be invested.

I chair Columbia's Advisory Committee on Socially Responsible Investing. We review the University's portfolio and recommend to the trustees which funds and companies we should and should not be investing in. All the other major private and public universities have SRI committees, as do large philanthropic organizations like the Ford Foundation and the Rockefeller Foundation. None of these institutions' investments are formally classified as SRI funds, so that 10 to 12 percent is probably something of an understatement.

TOYOTA believed that environmental issues would begin to constrain the automobile industry, and placed the company strategically to react to that.

Q. To what extent is pressure from consumers driving corporate social responsibility (CSR) efforts and success, as opposed to doing good for its own sake or strictly because it has an ethical component to it?

avoid dealing with it. Consumers are increasingly concerned about environmental and social issues and are asking questions about the goods they buy: Was this product made with sweatshop labor?

Q. Do you foresee a day when every corporation must respond to consumer concerns by integrating CSR into its operations?

A. No, not every corporation. Defense contractors and weapons firms are quite large and are significantly immune from the forces we are talking about here. It doesn't mean they are behaving badly, and whether you or I approve or disapprove of what they are selling doesn't make any difference. But most industries are not immune to CSR.

Q. What about industries facing pressure to adopt CSR measures but for which CSR requires a daunting investment?

A. In most cases it's a simple matter of leadership. The car industry is interesting. Responding to environmental concerns may be challenging for the automakers, but Toyota anticipated it. Toyota believed that environmental issues would begin to constrain the industry, and placed the company strategically to react to that. Toyota put together a very high-powered team of people to determine what sort of product they needed; they started designing the Prius seven years before it appeared on the market. Honda took similar steps with its Civic, Accord and Insight models.

I suspect leadership in the U.S. auto industry decided to just go with the SUV flow instead, and now that approach is hurting them. The U.S. industry is recognizing that it will have to reconcile its vehicles with the public's concern with environmental issues. There's a lot of emphasis on Chevy's forthcoming electric vehicle, the Volt, but the industry has been dragged into innovating and is still lobbying against effective policy measures.

Q. You mention brand image as a factor in CSR, but in the book you are quite adamant about distinguishing CSR from cosmetic efforts aimed at building brand image.

A. CSR is a carefully thought-out response to minimize companies' social and environmental impacts. If a tobacco company gives money to the Metropolitan Opera, it may be good philanthropy and it



may be good public relations, but it's not CSR because it does not address the social and environmental problems caused by a tobacco company.

Consider Starbucks, which has gone to some lengths to minimize the negative environmental impact of growing coffee. Starbucks pays its employees at a higher rate than is typical in the retail food trade, it offers employees more benefits and it buys from fair-trade growers as much as possible. Starbucks has fought through the classical social and environmental problems associated with being in that business.

Q. Measuring the impact of CSR in achieving social and environmental goals has been difficult. What do you think are going to be the best, most effective ways to do that?

A. Companies do spend a fair amount of time producing CSR reports, but at the moment they are a bit of a missed opportunity—they don't really say very much.

There's the old saying that what gets measured gets managed. There are ways of measuring environmental impact; we can measure the pollution that companies produce, for instance. It is much tougher

to measure social issues. For example, how can contributions to gender equity be measured? But we can move toward quantifying those to a greater degree than we do now.

On the environmental side, we could have reporting that is much closer in general format to the GAAP than we now have. We could actually compare across companies in terms of their environmental impacts. The Global Reporting Initiative has tried to standardize the format, but without

addressing quantification. I'd like to see reports and audits be standardized and quantified as far as possible.

I'd also like to see internal and external reporting become the standard. There are very compelling reasons why we have audits for our regular financial accounts. People have a tendency to misstate things in their own interests—that's unavoidable. If you want consumers to take the numbers in these reports seriously, the numbers have to be credible, and that means external review by a neutral third party.

Ultimately, we need internal reporting, external auditing, quantification and standardization to really make CSR reports more operational. But I think it's all very doable.

Read More

Heal, Geoffrey. *When Principles Pay*. New York: Columbia University Press, Columbia Business School Publishing, 2008.

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IN THIS ISSUE . . .

Ko Kuwabara explores how social networks help explain **cultural differences in trust**. Donald Lehmann explains **why consumers often overlook the advice of experts**, and Doron Nissim and Stephen Penman **lay out principles** for the use of fair-value accounting. Olivier Toubia offers a new market-research methodology that **cuts costs while considering context**. Other features illustrate how categorization can **make choosing from many options easier**, and gauge whether **economy airlines** should offer last-minute bargains. Research briefs identify specific **brand attributes that raise stock returns**, and assess **optimal task specialization** to foster adaptive organizations.

To read more about the ideas covered in this issue — and to explore research findings on other business topics — visit the Columbia Ideas at Work Web site:

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