19th Annual
Robert Mittelstaedt Doctoral Symposium Proceedings

April 1 – 3, 2010

Doctoral Research in Marketing

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ACKNOWLEDGEMENT

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ROBERT MITTELSTAEDT DOCTORAL SYMPOSIUM

"If I were there I would be saying that the word “symposium” comes from the Greek word “symposion” which, in turn, derives from the Greek verb “sympeninein” which means to drink together. The Merriam Webster dictionary defines symposium as “a convivial party with music and conversation” or “a social gathering at which there is free interchange of ideas.” While the music may be in short supply, I trust that all of you – and especially those of you for whom this is your first time at a meeting like this – find this symposium both intellectually stimulating and socially rewarding. So, again, welcome to the Robert Mittelstaedt Doctoral Symposium."

- Robert Mittelstaedt

Dr. Robert Mittelstaedt retired on August 31, 2002, after 29 years of contributions to the University of Nebraska–Lincoln, College of Business Administration, Marketing Department and our graduate program.

Doctoral students share a common link to Bob. He was more than a fine educator, scholar, and academic citizen. He was also their mentor, friend, counselor, and supporter. He motivated them with his insights, kindness, and countless stories. He stimulated their ideas, made them smile, and warmed their spirits. In addition, Bob and Venita opened their home and hearts to many doctoral students and gave them many forms of moral support. Bob dedicated his career to doctoral education and has served as a role model to both doctoral students and junior faculty.

Bob also introduced macromarketing theory and issues to doctoral students and inspired them, for over 40 years. He has been more than a fine educator and scholar. His insights, seminars, and dedication to the Journal of Macromarketing and Macromarketing Conferences motivated their investigations of important issues in the field, presentations at the Conferences, and publications in JMM.

Despite being retired, Bob was lured back to the department for the 2004 and 2005 fall semesters to teach doctoral seminars.

At the time of Bob’s retirement, the faculty in the Department of Marketing decided to rename the Nebraska Doctoral Symposium to the Robert Mittelstaedt Doctoral Symposium in honor of Bob’s accomplishments at the University of Nebraska–Lincoln.
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PROGRAM

19TH ANNUAL
ROBERT MITTELSTAEDT DOCTORAL SYMPOSIUM
DOCTORAL RESEARCH IN MARKETING
APRIL 1 – 3, 2010

THURSDAY, APRIL 1 – AFTERNOON

Guests check in at the Embassy Suites, 1040 P Street, (402) 474-1111

THURSDAY, APRIL 1– EVENING (DRESS CASUALLY)

7:15  Meet in lobby of Embassy Suites for ride to cocktail party

7:30 - 10:00  Cocktail Party
Home of Jim and Ruth Gentry, 2809 Woodsdale Blvd.
Finger-foods will be served

FRIDAY, APRIL 2 – MORNING (DRESS PROFESSIONALLY)
LOCATION: REGENTS A, EMBASSY SUITES

Breakfast available for guests staying at the Embassy Suites

8:45 – 9:00  Welcome
Dr. Jim Gentry, Mittelstaedt Doctoral Symposium Coordinator
Interim Dean John Anderson, College of Business Administration
Dr. Robert Mittelstaedt, Nathan J. Gold Distinguished Professorship in
Marketing, Emeritus

9:00 – 9:30  Shannon Cummins, University of Nebraska–Lincoln
“Do Board Member Power Blocs Improve Firm Innovation and Performance?”

9:30 – 9:40  Discussant: Duane Myer, University of Kansas

9:40 – 9:50  General Discussion

9:50 – 10:00  Break
10:00 – 10:30 James M. Loveland, Arizona State University
“Understanding Extended Warranties: Effects on Brand Equity and Willingness to Pay”

10:30 – 10:40 Discussant: Shipra Gupta, University of Nebraska–Lincoln

10:40 – 10:50 General Discussion

10:50 – 11:00 Break

11:00 – 11:30 David Gilliam, Oklahoma State University
“Story Telling by the Sales Force”

11:30 – 11:40 Discussant: Irina Kozlenkova, University of Missouri

11:40 – 11:50 General Discussion

11:50 – 1:00 Lunch in the Atrium area, Embassy Suites

FRIDAY, APRIL 2 – AFTERNOON
LOCATION: REGENTS A, EMBASSY SUITES

1:00 – 1:30 Eda Gurel-Atay, University of Oregon
“Celebrity Endorsements and Advertising Effectiveness”

1:30 – 1:40 Discussant: Justine Rapp, University of Nebraska–Lincoln

1:40 – 1:50 General Discussion

1:50 – 2:00 Break

2:00 – 2:30 Hyun Jeong Min, University of Utah
“Do We Possess Our Body? Exploring the Body as Subject through the Experiences of Pregnancy”

2:30 – 2:40 Discussant: Scott Owen, University of Oregon

2:40 – 2:50 General Discussion

2:50 – 3:00 Break

3:00 – 3:30 Brinja Meiseberg, University of Oklahoma
“Social Capital Transfer and Performance in Franchising”

3:30 – 3:40 Discussant: Jeff Johnson, University of Nebraska–Lincoln
3:40 – 3:50  General Discussion
3:50 – 4:00  Break
4:00 – 4:30  Hyo Jin Jeon, University of Oklahoma
            “Correlates of Successful Franchise Performance”
4:30 – 4:40  Discussant: Mark Mulder, Washington State University
4:40 – 4:50  General Discussion

**Friday, April 2 – Evening (dress casually)**

**Location:** Regents DEF, Embassy Suites

6:30 – 9:00  Evening Reception and Banquet
            6:30 - Cocktails
            7:00 - Banquet

9:00 – late  On your own

**Saturday, April 3 – Morning (dress professionally)**

**Location:** Regents A, Embassy Suites

Breakfast available for guests staying at the Embassy Suites

9:00 – 9:30  Chris Hinsch, University of Missouri
            “Customer Delight and Its Impact on Felt Relatedness”
9:30 – 9:40  Discussant: Kelly Moore, Iowa State University
9:40 – 9:50  General Discussion
9:50 – 10:00  Break
10:00 – 10:30  LiShan Su, Iowa State University
              “Impact of Media Coverage of Economic News on Consumer Confidence”
10:30 – 10:40  Discussant: Nguyen-Nga Ho-Dac, University of Utah
10:40 – 10:50  General Discussion
10:50 – 11:00  Break
11:00 – 11:30  Zelin Zhang, University of Kansas
“Design and Pricing of Probabilistic Quality”

11:30 – 11:40  Discussant:  Jay Yoo, Oklahoma State University

11:45 – 11:50  General Discussion

11:50 – 12:00  Closing

12:00  Box lunches will be available for those who requested them
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April 1 - 3, 2010

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DO BOARD MEMBER POWER BLOCS INCREASE FIRM INNOVATION AND PERFORMANCE?

Shannon Cummins & Ravipreet S. Sohi, University of Nebraska–Lincoln

ABSTRACT

This paper introduces intra-industry board member Power Blocs, a type of interlocking directorate, to the marketing literature. Using a sample of 80 companies across 12 industries, the authors test hypotheses related to: (1) the effects of Power Blocs on (a) firm innovation, and (b) firm performance (sales, profit, and ROA); (2) moderating effects of industry competition and environmental turbulence. The results show that contrary to conventional thinking, Power Blocs do not have an anti-competitive effect as they don’t result in higher sales for firms. Instead, they increase firms’ innovativeness, profitability, and ROA. Industry competition enhances the positive effect of Power Blocs on innovation, but does not impact the other variables. Environmental turbulence on the other hand, lessens the significant effect of Power Blocs on all the variables.

The board of directors provides leadership to firms and plays a critical role in their success or failure. Governance failures by boards of directors have been blamed for allowing the collapses of WorldCom, Tyco, and Enron (Byrnes 2010). Similarly, Toyota's recent troubles, including its public relations failures, have been partially attributed to the composition of its board. Its board was composed of 29 Japanese men, all Toyota insiders. Had it included some outsiders who were not brought up in the company's culture, and who were not afraid to ask tough questions, things might have been different (Economist 2010).

One way to bring an outside perspective is to invite directors from other companies to sit on the firm's board. Doing so links the companies via their board of directors, and this linkage is referred to as an interlocking directorate (ILD) (Mizruchi 1996). Traditionally, interlocking directorates were considered to have an anti-competitive effect and were seen as attempts by firms to co-opt the environment (Allen 1974; Burt 1983; Pennings 1980). Indeed, since the early part of the 20th century, there has been a ban on directors serving on the boards of competing companies (Brandeis 1913). However, several scholars have argued that interlocking directorates may be beneficial (e.g. DiMaggio and Powell 1983; Koenig and Gogel 1981; Palmer 1983). Researchers in several areas such as accounting, finance, and management have started investigating the impact of interlocking directorates on firm variables. In the marketing literature, scholars have recognized the effect of board members on marketing outcomes, and have investigated issues such as the impact of CEOs on firm innovation (Yadav et al. 2007). Research related to the impact of ILD's however, is still in a nascent stage.

From a marketing perspective, boards of directors and interlocking directorates are important intangible assets of the firm (Falkenberg 1996). The composition of the board can determine the strategic marketing direction of the firm. Further, board members are conduits of information flow and offer valuable insights that may help shape marketing strategy. The linkages they form with other companies through ILDs, help build human and relational capital for the firm (Wincent et al. 2010). These linkages may have beneficial effects for the firm, or conversely as viewed by policy makers, could create unfair advantages and have anti-competitive effects. Given this, the purpose of our study is to investigate the impact of ILDs on outcomes that are important to marketing strategy.

As we discuss in the next section, ILDs may be in the form of direct linkages, or indirect linkages, between firms. Another form of ILD that incorporates both direct and indirect ties, is a board member Power Bloc, consisting of four firms linked by directors who sit on the boards of two or more of these firms (Hayden et al. 2002). In this study, we use the Power Bloc form of ILDs to investigate the following
research questions: (1) What effects do board member Power Blocs have on a firm’s (a) innovativeness
and (b) performance (sales, profitability, and ROA)? (2) How are these effects influenced by industry
competition and environmental turbulence?

To address these research questions, we identified unique Power blocs in a sample of 80 firms
belonging to 12 industries. Contrary to conventional thought, our results show that Power Blocs do not
have an anti-competitive effect since they do not result in increased sales for firms. Instead, they increase
firms’ innovativeness, profitability, and ROA. Industry competition enhances the positive effect of Power
Blocs on innovativeness, but environmental turbulence dampens all its significant effects. These results
have important marketing and public policy implications.

This study makes several contributions to the marketing literature. It introduces Power Blocs as a
mechanism for creating inter-organizational ties, and extends the marketing-finance interface literature by
exploring the impact of these ties on firm financial value. It adds to the marketing literature on networks
(Achrol and Kotler 1999), by showing that Power Blocs are another form of network that can be used to
leverage synergies within an industry. It also makes a contribution to the emergent marketing literature on
coopetition (Luo et al. 2006; Rindfleisch and Moorman 2003) by suggesting that Power Blocs are a
mechanism for creating intra-industry coopetition. It extends the macro-marketing literature by showing
that board members are not only value-creating internal firm assets (Falkenberg 1996), but can also
become valuable external assets through Power Bloc networks. Finally, it makes a contribution to the
public policy literature by demonstrating that the inter-organizational linkages created by Power Blocs
can be beneficial and do not have anti-competitive effects.

THEORETICAL BACKGROUND AND LITERATURE REVIEW

Boards of directors play a crucial role in forming and regulating key business decisions. Very often,
board members of one company sit on the boards of other companies, forming what are called
interlocking directorates (ILDs). Interlocking directorates are defined as the presence of a person
affiliated with one organization, often as a board member, sitting on the board of directors of another
organization (Mizruchi and Stearns 1988). The connection forms a bond between the respective
organizations (Pennings 1980).

There are three main types of interlocking directorates—direct interlocks, indirect interlocks, and
Power Blocs (Hayden et al. 2002; Mizruchi 1996). Direct interlocks occur when one or more board
members sit on two boards simultaneously, creating a direct link between the two firms. Indirect
interlocks are more difficult to identify and occur when two individuals from separate organizations both
sit on the board of a third organization. In indirect interlocks, the first two organizations are connected by
the presence of their board members on a common, third board. Power Blocs consist of four firms, linked
by directors who sit on two or more of these firms’ boards. For example, Textron ↔ Boeing ↔ DRS ↔
United Industrial Corporation are an actual Power Bloc within the aerospace and defense industry found
in this study, with each set of directed arrows representing a director shared by the two firms it connects.
The packaged food firms of Del Monte ↔ Kellogg ↔ Kraft ↔ ConAgra form another Power Bloc found
in this study.
Figure 1: Types of Board Member Interlocks

Power Blocs serve as means of incorporating indirect ties into formal board structures. Through shared directors, they allow firms to share information ranging from market conditions to customer developments. They even enable firms to coordinate action. A real world example of this is presented by Hayden et al. (2002), who describes how the CEOs of three firms (Peter Kiewit, Berkshire Hathaway, and CalEnergy) connected in numerous different Power Blocs, simultaneously began acquisition of the public utility, MidAmerican Energy. At the same time, each firm’s CEO lobbied different Washington D.C. decision makers to rescind legislation that would disallow expanded ownership of utilities.

Extant Literature

Several studies have looked at the prevalence and role of interlocking directorates. This body of research focuses on four theories of ILD impact. First, ILDs are viewed as a means of firm collusion to reduce competition or regulation (e.g. Burt 1983; Pennings 1980). This viewpoint led to the prohibition of board interlocks in the early twentieth century. Second, ILD linkages are viewed as a means of conveying legitimacy to relevant market agents including sources of capital (e.g. DiMaggio and Powell 1983). Third, ILDs are viewed as a means for interdependent firms to monitor and control uncertainty (e.g. Allen 1974; Bunting 1976; Dooley 1969; Galaskiewicz et al. 1985; Lang and Lockhart 1990; Mizruchi and Stearns 1988; Pfeffer and Salancik 1978). Finally, ILDs are presented as a tool to create social cohesion among business and political elite (Koenig et al. 1979; Mintz and Schwartz 1981; Mizruchi 1982; Palmer 1983; Palmer et al. 1986; Useem 1984).
Research Gaps and Unexplored Issues

Despite the preponderance of ILD literature, there are several research gaps that need to be addressed. The first research gap pertains to the type of ILDs investigated in the literature. Most studies have looked at direct linkages because they are easy to identify and understand. Empirical research on indirect linkages is very limited, but is gaining attention (Carbonai and Di Bartolomeo 2006; Lyson and Raymer 2000). Further, with the exception of Hayden, Wood and Kaya (2002), no one has looked at the role and impact of Power Blocs. It is important to study Power Blocs because they connect the direct linkages most often studied in literature with the increasing attention toward indirect linkages. Power Blocs represent a more complete view of board of director network connections. The benefits of utilizing a Power Bloc measure are four-fold. First, Power Blocs link extensive revenues, knowledge, and assets. Second, they allow for coordinated action and planning across a wider array of firms and industries. Third, a single Power Bloc can be studied in regard to its interlocks with other Power Blocs, further expanding our understanding of network power beyond individual linkages. Fourth, the Power Bloc approach to describing and analyzing horizontal directorship ties allows a more complete understanding of how tightly a governing network is woven (Hayden et al. 2002).

The second research gap relates to the potential outcomes of ILDs. Researchers have investigated potential negative outcomes associated with ILDs and indicate that board interlocks allow firms to coordinate pricing strategies and defeat the forces of market competition (Burt 1983; Pennings 1980). However, few studies have looked at the possible positive benefits that may emerge from ILDs. In order to have a balanced view of interlocks, it is important to expand the research beyond negative outcomes and study the impact of ILDs on important strategic variables such as firm innovativeness and performance.

Related to this, a third research gap is with respect to the role of ILDs in managing firm resources. Extant research has explored how firms utilize ILDs to manage external resources at the firm level (Klein 2002; Schoorman et al. 1981) or industry level (An and Jin 2004; Hayden et al. 2002; Mampaey and Serfati 2006). Yet, a gap exists as to whether ILDs aid firms in managing internal resources that could impact strategic outcomes.

Related to the second research gap, another gap pertains to the interaction between ILDs and environmental variables. Several researchers have indicated that firms compose their boards and form ILDs as a strategy to co-opt the environment and manage uncertainty (Allen 1974; Bunting 1976; Burt 1983; Dooley 1969; Galaskiewicz et al. 1985; Lang and Lockhart 1990; Mizruchi and Stearns 1988; Palmer et al. 1986; Pennings 1980; Pfeffer and Salancik 1978). While some firms may have the intent of co-optation, most companies do not have the power and resources to do so. Further, some firms may be able to choose their operating environment and manage uncertainty, but most cannot—these firms must operate within an existing environment. The existing literature does not provide guidance on how a firm’s operating environment (in terms of competition, uncertainty, etc.) may impact the effects of ILDs on strategic outcomes.

Our paper addresses these research gaps by investigating the effects of Power Blocs on strategic firm outcomes, and also exploring how these outcomes are impacted by variables in the firm’s external operating environment.

MODEL AND HYPOTHESES

With regard to the research gaps identified, and with respect to the specific variables in the model, we examine the effects of Power Blocs on two types of firm outcomes—firm innovativeness and firm performance (assessed in terms of profitability, ROA, and sales revenue). We investigate how these effects are moderated by two external environmental variables—industry competition and market
turbulence. In this section, we first describe the model variables and discuss the theory and rationale underlying their selection. Next, we develop the hypotheses.

**Outcome Variables**

**Firm Innovation**

Innovation is a well-accepted source of strategic advantage (Han et al. 1998). While innovation has been investigated in terms of new and creative products, processes, organizational forms and structures, its conventional definition and most used application is that of technical innovations pertaining to products, services, and production process technology (Barnes 1984; Stevenson 1976). While other forms of innovation occur and impact organizational performance, technical innovations based in product or process advances occur most frequently (Katila 2000) and impact managers’ decisions most (Hillman and Dalziel 2003; Richardson 1987). As a key determinant of firm success, innovation is studied here through the use of patent data, which provides a means of monitoring firms’ overall innovative performance (Han et al. 1998; Hurley and Hult 1998).

**Firm Financial Performance**

Firm financial performance is a strategic variable of great importance, and it has been the goal of several studies to examine its determinants (Hansen and Wernerfelt 1989; Huselid et al. 1997; Kotha and Nair 1995). As organizations increasingly focus on improving economic value, it is critical to understand the impact of non-tangible firm assets on the financial performance of firms (Zinkhan and Verbrugge 2000).

Financial performance of firms is typically measured in terms of profitability, return on assets (ROA) and sales revenue (Anderson and Mansi 2009; David et al. 2002; de Chematony et al. 1998; McGuire et al. 1988). Profitability is established as a key metric in evaluating success of marketing variables (de Chematony et al. 1998). ROA is a common measure considered one of the preferred accounting based metrics of firm performance (Hansen and Wernerfelt 1989; McGuire et al. 1988). Sales revenue is a useful measure of a firm’s customer-viewed performance (Ittner and Larcker 1998). Consistent with prior literature, we use profitability, ROA, and sales revenue as indicators of firm financial performance.

**Moderating Variables**

**Industry Competition**

The importance of industry competition on firm outcomes is noted as being “beyond dispute” (Hansen and Wernerfelt 1989 p. 400; Ravenscraft 1983). It is widely contended that the structure and intensity of competition is the main determinant of overall firm financial performance and efficiency, and a firm’s ability to operate within and with regard to this competition determines competitive advantage (Porter 1980). Competition impacts both macro and micro firm decisions and is shown to influence managerial marketing mix and organizational structure variables from pricing (Eliashberg and Jeuland 1986) to market orientation (Pelham and Wilson 1996). As firms have no choice but to contend with changing competitive environments that impact every aspect of their operations, competition is included as a moderating variable in this study.

**Environmental Turbulence**

Environmental turbulence refers to volatility or difficult-to-predict discontinuities in an environment (Aldrich 2007; Haleblian and Finkelstein 1993; Keats and Hitt 1988). The concept is a central variable in theories of organizational design (Burns and Stalker 1961; Crozier 1964; Galbraith 1973; Lawrence and Lorsch 1967; Milliken 1987) as theorists emphasize that firms must adapt to their external environment in order to remain viable (Duncan 1972). The importance of environmental turbulence is recognized as a factor in strategy formation and execution even by those who profess a strategic choice model where
management is conceived of having near total control over firm strategy (Bluedorn et al. 1994 p. 202). For these reasons, environmental turbulence is included as another moderating variable.

Hypotheses

Effect of Board Member Power Blocs on Firm Innovation

Power Blocs enable firms to connect to new and valuable information held outside the organization. Research has shown that board of directors form networks that operate both within and without the focal firm. Unlike employees, board members are not tied to one firm, but are embedded in a larger social network with relevant market agents outside the focal firm (Carter et al. 2003; Hoy and Verser 1994). As high-level, yet often periphery members of the firm, board members have a multitude of weak-ties that provide access to valuable information about third-party market agents such as competitors, suppliers, and customers (Schoorman et al. 1981).

Improved firm access and use of relevant market information enhances the firm’s market orientation. Market orientation is based on three core competencies: information gathering, dissemination, and utilization (Slater and Narver 1994). Board interlocks are shown to improve information gathering (Harrigan 1988; Webster 1992). They are also highly influential in disseminating information into the firm (Mintz and Schwartz 1985; Mintz and Schwartz 1985; Mintz and Schwartz 1985; Mintz and Schwartz 1985; Mintz and Schwartz 1985; Mintz and Schwartz 1985). Utilization of information is the third component of a market orientation, and requires a firm-wide focus. Boards are integral to the creation of this firm-wide focus by forming an information-driven corporate culture (Kotabe and Swan 1995). Additionally, board members are influential in the use of market information in strategy development, and they are influential in choosing and monitoring executives who oversee strategic execution (Westphal and Fredrickson 2001).

Power Bloc linkages to external market agents through board networks provide access to new and relevant market information and influence a firm’s creation of a market orientation. Together, access to this valuable information and a market orientation enhance the firm’s ability to innovate. Innovation requires access to new information, which board member Power Blocs can provide. Highly innovative firms are found to have a market orientation focusing on the three core competencies of information gathering, dissemination, and utilization (Han et al. 1998; Hurley and Hult 1998) that Power Blocs help form. These three information competencies, as well as firm innovation, have been linked to a firms’ formation of outside linkages and networks (Davis and Greve 1997; Koenig and Gogel 1981; Lyson and Raymer 2000); and have also been linked to cooperation between firms (Ahuja 2000; Gargiulo and Benassi 2000; Rowley et al. 2000). In addition to forming outside linkages, inter-firm networks, and enhancing cooperation between firms, shared board members create interorganizational relationships that are shown to enhance firm innovation and patenting by tapping into external knowledge stores (Davis and Greve 1997; Koenig and Gogel 1981; Lyson and Raymer 2000; Richardson 1987). Finally, Power Blocs are a form of social network (Baek et al. 2004; John and Senbet 1998; Pinkowitz et al. 2006), which have been found to positively impact firm innovation (Liebeskind 1996; Liebeskind et al. 1996).

Based on the preceding discussion, we offer our first hypothesis.

H1: There is a positive relationship between Power Blocs and firm innovation.

Effect of Board Member Power Blocs on Firm Performance

As discussed in the previous hypothesis, board member Power Blocs can play an instrumental role in creating a market-oriented corporate culture. Market orientation, shared across all levels and departments of a firm, is shown to positively influence firm financial performance (Kohli and Jaworski 1990).
Additionally, linkages through board memberships form the basis of social networks among directors (Porter 1998). Research has shown that social networks of directors and top management organize and create corporate social performance (CSP) activities that enhance firm financial performance (Hull and Rothenberg 2008). The reason for this is firm differentiation. Network created CSP activities can act to differentiate a firm, and firms that differentiate their activities typically earn above-average returns (Mackey et al. 2007; Siegel and Vitaliano 2007).

Boards also play a key role in firm governance, which has been shown to impact the financial decisions and performance of firms by enhancing their ability to make unbiased judgments and decreasing agency conflict among top leaders (Fama and Jensen 1983; Jensen 1993; Wayland 1998). Further, boards determine compensation levels and structure for top executives, which have been shown to influence firm performance (Mehran 1995). Power Blocs can enable access to best practice information on governance issues and executive compensation, thereby enhancing the positive effects of boards on firms’ financial performance.

H2: There is a positive relationship between Power Blocs and firm performance in terms of (a) firm profitability, (b) firm return on assets, and (c) firm sales revenue.

Moderating Impact of Industry Competition
When industry competition increases, firms have to compete harder for market share, customers, and suppliers (Porter 1980). This heightens the importance of Power Blocs since they can help in transferring specific resources, acquiring commitments or support, and establishing legitimacy of the focal organization with key business partners (Mizruchi 1983; Schoorman et al. 1981).

Firms operating within highly competitive industries also have more direct competitors to monitor. These competitors can poach clientele and suppliers, and change market standards through innovation. Yet, firms in competition have fewer resources to devote to monitoring of market, customer, supplier, and competitor changes (Januszewski et al. 2002). Power Blocs help reduce this imbalance by providing access to network resources and stimulating resource exchange. Not only do director networks reduce the resource burden on the firm, freeing up resources for critical tasks, but when these network resources are efficiently deployed across organizational boundaries, they can become engines of innovation (Dhanaraj and Parkhe, 2006), helping increase firm innovation levels.

When industry competition increases, firms must also find ways to improve financial performance by increasing revenue, cutting costs, and increasing efficiencies. Networks such as Power Blocs can assist companies by giving advice, providing access to network knowledge, and helping solicit commitments or support from important outside elements (Pfeffer and Salancik 1978; Wincent et al. 2010). Performing these actions enhances Power Blocs role in improving firm performance. Therefore, we hypothesize that:

H3: An increase in industry competition enhances the positive relationship between Power Blocs and firm innovation.

H4: An increase in industry competition enhances the positive relationship between Power Blocs and firms’ performance in terms of (a) profitability, (b) return on assets, and (c) sales revenue.

Moderating Impact of Environmental Turbulence
A primary concern for organizations is how to manage turbulent industry environments characterized by shorter strategic planning horizons (Kukalis 1991), rapid obsolescence of knowledge, and difficulty in acquiring and processing information, which is often sparse and contradictory (Vandenbosch and Huff 1997).
In such environments, the importance of higher level firm planning and decision making becomes extremely important (Gilmore and Brandenburg 1962; Grinyer 1971). Board member Power Blocs can facilitate this strategic process. Johnson et al. (1996) specify that a board can significantly assist with strategy formulation and implementation, as well as support executives with administrative and other managerial issues. Additionally, Carpenter and Westphal (2001) found that boards of directors with ties to strategically related organizations provided better advice and counsel, which is hypothesized to improve member firms' innovative performance.

In order to improve strategic decision making in environmentally turbulent times, where information gets quickly dated, firms must constantly acquire new information and update their knowledge stores (Johnson et al. 2004). Power Blocs can help by providing “board capital” (Hillman and Dalziel 2003). Through “board capital,” which includes human and social capital, directors bring unique experiences and expertise to the board. They also create ties amongst companies, which facilitate knowledge development (Lechner and Dowling 2003). These network ties and links provide unique information flows (Uzzi and Lancaster 2004), and can ensure critical know-how is available to a company (Kale et al. 2000). They also provide a host of advantages including complementary skills (Eisenhardt and Schoonhoven 1996), extra legitimacy for getting access to new markets and technologies (Grandori and Soda 1995), and information about innovative endeavors that others have adopted or developed (Biemans 1991). Further, they facilitate access to strategic information and opportunities, exposing information about other firms' agendas and operations (Pfeffer 1991; Useem 1984). In addition, they can help firms exploit network knowledge in terms of who knows what and who can help with what problem (Cohen and Levinthal 1990). Power Blocs can also bring functional diversity in terms of knowledge and skills, generating a diverse opinion set, and an opportunity to pool information and combine ideas (Jehn et al. 1999; Kickul and Gundry 2001; Van der Vegt and Janssen 2003).

These benefits provided by Power Blocs, especially in terms of higher-level decision making, access to strategic information, and exploitation of network knowledge can increase firm innovativeness and performance. The need for these benefits becomes more crucial in turbulent environments, increasing the importance of Power Blocs, and potentially enhancing their effects on the outcomes of interest. Therefore, we offer the following hypotheses:

H5: An increase in environmental turbulence enhances the positive relationship between Power Blocs and firm innovation.

H6: An increase in environmental turbulences enhances the positive relationship between Power Blocs and firm performance in terms of (a) profitability, (b) return on assets, and (c) sales revenue.

METHOD

Sample
To investigate the hypotheses, this study utilizes a sample of firms across industries, but with a common customer. The sample consists of 80 large public companies who are primary suppliers of the U.S. Department of Defense (DOD). The companies were identified from a listing of top DOD suppliers obtained from researchers at the U.S. Government Accountability Office (GAO). The sample was chosen due to both the consistency and variability it offers. Across the 80 firms, the GAO data shows all are primary suppliers of the DOD and earn large portions of firm revenue from contracts with this common customer. For this reason, these companies are unique competitors with a single customer. However, as the DOD purchases products from pre-packaged meals to missile defense systems, there is also much variety in their supplier base. Among the 80 firms are packaged food firms such as Del Monte and Sara Lee, communications providers such as Motorola and Sprint Nextel, and aerospace providers such as Lockheed Martin and Boeing. This variety in suppliers across industries, yet with the same major
customer, allows for comparisons across competition and turbulence levels. From the original sample, two firms were excluded due to private ownership and the associated inability to obtain fiscal data on the firm. Five firms were excluded due to either being acquired, or being wholly owned subsidiaries of, another firm in the sample during the 2007, 2008 fiscal years.

**Measures**

**Board Member Power Blocs**

The process of obtaining information on the interlocks of DOD supplier firms was undertaken in four steps. First, the 30 largest public DOD suppliers were identified and a listing of each firm’s 2007 board members was compiled using *InfoUSA*, *Mergent Online*, and the *Million Dollar Directory*. Second, these individual directors were searched using *InfoUSA* and *Mergent Online* to identify the other boards on which they sit. Only exact matches were included in the study. For example, if a director’s middle initial was included by an original firm, but not by a subsequent firm, efforts were made to ascertain if this director was the same person before an interlock was identified. Third, with a list of all of the firms on which members of the original 30 firms’ directors sit, the board membership of these firms was identified. Fourth, all firms on which these individuals serve as board members, were compiled. This compilation resulted in 996 companies. Figure 1 provides an example of the process undergone for one individual board member of a single focal firm.

At this point, the 80 firms identified as leading DOD suppliers that were also within the list of 996 interlocked firms were pulled for further analysis. The 80 firms were divided into 12 industries after reviewing both the firms’ SIC codes and their primary contracts with the DOD. A Power Bloc analysis on these firms was conducted by which the number of unique Power Blocs that a firm belonged to within the firms’ own industry was identified. Importantly, a Power Bloc was not counted more than once if the same four firms were involved, but in a different order. For example, a Power Bloc identified in this process with all members in the aerospace/defense industry is as follows: Textron↔Boeing↔DRS↔United Industrial Corporation. If a separate Power Bloc was identified as Boeing↔Textron↔DRS↔United Industrial Corporation, it was not counted so as to not artificially inflate the number of industry Power Blocs. It is important to note that we focus on unique within-industry identification of Power Blocs. By doing so, we are able to look at industry-specific knowledge and linkages. For example, aerospace firms are likely to benefit most from contact and cooperation with other aerospace firms.

Power Bloc analyses for each firm were run, using a specially designed sorting algorithm that identified all board member linkages between firms, and further sorted these interlocks into linear 4-firm Power Blocs. The analysis results give the number of unique Power Blocs connecting a single firm to at least one other firm within its own industry. Consistent with past research (Hayden et al. 2002), the results for each firm ranged from zero to over 5,000 unique Power Blocs within industries, demonstrating the prevalence of board member Power Blocs.
Industry Competition

We computed structural competition as within-industry concentration ratios based on sales revenue. While there are many measures of competition that can broadly be broken into structural and non-structural, we chose the more often utilized structural measure of competition. In structural approaches, concentration ratios take a central position in order to describe the market structure, forging a link between concentration and competition—the greater the concentration, the less the competition. The impact of market concentration on market performance has its roots in both oligopoly theory and the structure-conduct-performance paradigm. Concentration ratios provide an industry-wide measure of the fewness of major market players (Graves and Langowitz 1993).

We grouped each firm in the sample by SIC code and compiled the 2007 total sales for all firms in each SIC group using the COMPSTAT North America Fundamentals Annual Database. We then computed the concentration ratio for each industry as the as the total value of sales for the industry’s top four firms divided by the value of the industry’s top ten firms (Chatterji 2009; Graves and Langowitz 1993; Roberts 1999). For two firms within closely related SIC codes and with similar DOD contracts, there were too few firms in 2007 to compute the ratio individually so the industry codes were combined to form one concentration ratio.

Environmental Turbulence

We computed a measure of environmental turbulence using the method put forth by Johnson, Sohi and Grewal (2004). Secondary data from trade literature, government documents, and the popular press was gathered regarding each industry’s overall product introduction, market changes, industry structural shifts, regulatory changes, industry structural changes (e.g., mergers, acquisitions, alliances), and technical changes. This information was presented for review to 77 MBA students who, through a three-step process, rated the industries on both demand and technical turbulence on 100 point scales ranging from zero (no turbulence) to 100 (total turbulence). First, the student’s were broken into groups, each of which independently reviewed relevant information for the assigned industry and added information they believed to be pertinent. Each group shared this information with the class and each individual rated the industries. Next, groups were formed based on the ratings given—students with high ratings for an industry formed one group while students rating that industry low in turbulence formed another. Each group detailed and shared the reasoning and additional information guiding the difference in their ratings from the other group. At this point, individuals were allowed to modify their own ratings according to the information and arguments presented. Finally, the ratings of each student for each industry were averaged to generate the final ratings. Variation among the 77 participants was low.
**Control Variable**

We included the size of the firm, as measured by the number of employees, as a control in the analyses. We obtained the employee count from the COMPUSTAT North America Fundamentals Annual database for fiscal year 2008-2009. By including this control measure, we were able to account for the possible impact of firm size on innovation (Keil et al. 2008).

**Innovation**

We used patents applied for by the firms in this study in 2008 as a measure of firm innovation. Consistent with its use in the literature (see Ethiraj 2007), patents provide a useful way to measure a firm’s innovation performance (Anderson and Mansi 2009; David et al. 2002). To reflect the time of innovation, we recorded patents according to the application date instead of the granting date (Chen and Yur-Austin 2007; John and Senbet 1998). We obtained this information from the U.S. Patent Office for each firm in the analysis. As patent applications are the outcome of prior research and development efforts by a firm, we recorded 2008 patents as a means of accounting for the lag in R&D efforts (Anderson and Mansi 2009).

**Firm Financial Performance**

We assessed firm financial performance using measures of firm profitability, ROA, and sales. We obtained each measure from the COMPUSTAT North America Fundamentals Annual Database Online database for fiscal year 2008-2009. Please see Table 1 below for a detailed description each measure.

Table 1: Firm Value Measures

<table>
<thead>
<tr>
<th>Measure</th>
<th>COMPUSTAT Data Points (North American Fundamentals Annual Database FY 2008-2009)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Profitability = (earnings before interest, taxes, depreciation, amortization ÷ total assets)</td>
<td>EBIT ÷ ACT</td>
</tr>
<tr>
<td>Gross margin = (gross margin ÷ net sales)</td>
<td>GP ÷ SALE</td>
</tr>
<tr>
<td>Net sales</td>
<td>SALE</td>
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**ANALYSIS AND RESULTS**

We conducted a multiple regression analysis to investigate the hypotheses proposed. Since the variables were expressed in different units, we standardized them and used their z-scores in for the regression analysis (Cohen et al. 2003, pgs. 23-26). We checked for multicollinearity using both tolerance and Variance Inflation Factors (VIF). All tolerances were above .825 and VIFs ranged between 1.095 and 1.211. Since these numbers are within the recommended range (Mason and Perreault Jr 1991), multicollinearity is not a significant problem.

The specific tests of the individual hypotheses are as follows:

H1: As hypothesized, Power Blocs have a significant positive effect on firm innovation (Std. β = 9.68, t = 2.64, p < .01).

H2: Also as hypothesized, Power Blocs have a significant positive effect on firm financial performance in terms of ROA (Std. β = 10.54, t = 2.42, p < .01), and profitability (Std. β = 17.68, t = 5.24, p < .001). However, the effect of Power Blocs on sales is non-significant.

H3: As hypothesized, industry competition moderates the relationship between Power Blocs and firm innovation, enhancing the positive effect of Power Blocs on firm innovation (for the Power Bloc x Industry Competition interaction, Std. β = 0.62, t = 4.42, p < .001).
H4: Industry competition does not have a significant moderating effect on the relationship between Power Blocs and firm financial performance.

H5: Contrary to the hypothesis, environmental turbulence moderates the relationship between Power Blocs and firm innovativeness, but in a negative manner. An increase in environmental turbulence lowers the positive effect of Power Blocs on firm innovation (for the Power Bloc x Environmental Turbulence interaction term, Std. $\beta = -8.79$, $t = -2.45$, $p < .05$).

H6: Also, contrary to what we hypothesized, environmental turbulence has a negative moderating effect on the relationship between Power Blocs and two measures of firm financial performance—profitability and ROA. As environmental turbulence increases, the positive effect of Power Blocs on profitability and ROA is reduced (for profitability, the Std. $\beta$ for the Power Bloc x Environmental Turbulence interaction term is $-17.36$, $t = -5.26$, $p < .001$; for ROA, the Std. $\beta$ for the Power Bloc x Environmental Turbulence interaction term is $-10.45$, $t = -2.45$, $p < .05$). Both these moderating effects are opposite to what we hypothesized. Environmental turbulence however, does not significantly moderate the relationship between Power Blocs and sales revenues.

**DISCUSSION**

The goal of this study was to investigate the impact of board member Power Blocs on strategic outcome variables; namely, firm innovativeness and firm financial performance. We also wanted to investigate how the impact of Power Blocs on these outcomes is influenced by industry competition and environmental turbulence. While several of the findings are as hypothesized, we also found some interesting and counter-intuitive results.

In terms of the effects of Power Blocs on firm innovation, the findings are as hypothesized. Controlling for firm size, when firms engage in a larger number of board member Power Blocs, they are more innovative. With respect to firm performance, Power Blocs increase firm profitability and ROA; however, they do not have a significant effect on firm sales.

These results run counter to conventional wisdom guiding regulatory policy (Hayden et al. 2002; Mizruchi 1996), which views board interlocks as having potential anti-competitive and power-enhancing effects. Our findings show that while Power Blocs benefit firms in terms of innovativeness, higher profits, and ROA, they do not make them more dominant by increasing sales revenue.

With respect to the moderating effects of competition, the findings challenge the view that companies defeat the forces of market competition by creating board interlocks (Burt 1983; Pennings 1980). Our results show that when industry competition is higher, it does not change the positive effect of Power Blocs on firm performance. Rather, it enhances the role of Power Blocs in making firms more innovative.

The findings related to the moderating effect of environmental turbulence are opposite to what we hypothesized. Turbulence is found to significantly weaken the positive relationship between Power Blocs and firm innovation, profitability, ROA. These results are contrary to the conventional wisdom regarding the impact of board interlocks. ILDs are viewed as a means of neutralizing external environment risk, and are even proposed to be created in response to environmental uncertainty (Bunting 1976; Galaskiewicz et al. 1985; Lang and Lockhart 1990). Yet this study’s findings show that while Power Blocs benefit firms, this positive impact is lessened in turbulent times. We offer possible explanations for these findings.
For board member Power Blocs to influence innovation supporting and performance enhancing actions such as resource deployment to R&D and cross-functional organizational structures, directors and top management must retain strategic decision making authority. However, in times of environmental turbulence, firms tend to decentralize strategic decision making authority away from corporate (director/top management) control and toward business level control (Grinyer et al. 1986; Grinyer and McKiernan 1990; Lindsay and Rue 1980). This decreasing influence of corporate control may serve to lessen the impact of Power Blocs.

In addition, environmental uncertainty can shorten firms’ planning horizons (Kukalis 1991), causing decisions to be reached quickly, and firms to forfeit opportunities to gather outside information. While board member Power Blocs engage frequently with each other in non-formal and social situations (Koenig and Gogel 1981; Lyson and Raymer 2000), they interact formally with management often only quarterly or bi-annually. Due to the infrequency of board meetings and the shortening of decision windows, top managements’ opportunity to utilize Power Blocs’ knowledge and perspective may be limited in turbulent environments.

Additionally, it is possible that when high levels of industry turbulence and uncertainty threaten the success of some firms, cooperation and sharing of internal perspectives on industry demand and technology may appear dangerous. Simply, directors may feel threatened by market conditions and choose to conceal their knowledge in an attempt to insulate their own firm from the downside of environmental turbulence.

There may also be reluctance by firms’ to invest resources into developing new product and process innovations during times of industry environmental turbulence. Firms may be confronted with such fast-paced technological change that innovations become either obsolete or patented by another firm or industry. Given these circumstances, firms may choose not to act on market knowledge gained from Power Bloc networks, or even take risks associated with tying up resources in R&D. Forming alliances to share developments, may be alternatives that are more desirable in turbulent environments. For example, Monsanto and Pioneer, two agricultural seed competitors within a rapidly consolidating and innovative industry, recently chose to share protected innovations with one another instead of increasing patenting and patent enforcement of their respective innovations in seed genetic engineering (Pollack 2002).

**THEORETICAL CONTRIBUTIONS**

This study makes several theoretical contributions to marketing. The role of inter-organizational ties is well accepted in the marketing literature, whether they are at the same level (e.g. horizontal alliances), or at different levels (e.g. between buyer-seller organizations). Yet no one in marketing has looked at the role of board of directors in creating these ties. Our study introduces interlocking directorates and Power Blocs to the marketing literature as a means of creating inter-organizational ties. Since Power Blocs are composed of both direct and indirect board member ties between firms within an industry, they offer marketing scholars a means of operationalizing the extent of board-level linkages between firms. Our study further contributes by showing the impact of Power Blocs on central outcome variables within marketing strategy—firm innovativeness and firm performance. We also show how these effects are moderated by critical variables of industry competition and environmental turbulence.

The macro-marketing literature recognizes that valuable assets exist not only inside the firm, but also outside the firm (Falkenberg 1996). The role of marketing includes managing the complete value-creating network that surrounds the firm (Achrol and Kotler 1999). While the literature has treated directors as an internal value-creating asset (Falkenberg 1996), this paper makes a contribution by extending the understanding of board members to a role both internal and external to the firm. We show that board members are not only internal firm assets leading to value creation, but through external Power Bloc networks, are also valuable external assets.
Our study also contributes to the marketing literature on networks. Achrol and Kotler (1999) distinguish between four main types of network organizations—internal networks, vertical networks, intermarket networks, and opportunity networks. This study suggests that there is another category of network organization—that of the intra-industry firm network, which seeks to leverage horizontal synergies within an industry. These firms are neither purely competitive nor cooperative, but engage in linkages that will convey useful information about each others’ firm-level actions and industry-wide environmental concerns. They are engaged in a form of cross-functional “coopetition” (Nalebuff and Brandenburger 1996).

The concept of coopetition is emergent in the marketing literature (Luo et al. 2006; Rindfleisch and Moorman 2003), and researchers have called for increased investigation of the circumstances, outcomes, and mechanisms involved in coopetition. As Rindfleisch and Moorman (2003) note, scholars have paid little attention to interfirm coopetition, let alone intra-industry coopetition. We make a contribution to this literature, suggesting that board member Power Blocs are a mechanism for creating intra-industry coopetition.

Our paper also makes a contribution to the emergent literature on the marketing-finance interface. Within this literature, scholars have examined the financial impact of certain intangible marketing assets (e.g. brands, customer satisfaction, and customer equity) and corporate level decisions (e.g. product recalls, green marketing, international market expansion). Marketing scholars have also presented theoretical and empirical models of how intangible assets created through interaction with the external environment, and linkages with external partners, may lead to improved shareholder value of the firm (Srinivasan 2006; Srivastava et al. 1998). This paper extends these efforts by exploring the impact of external inter-organizational board linkages on firm financial value. Marketing scholars have also studied the interface of marketing and finance from a relational exchange perspective within the firm (de Ruyter and Wetzels 2000). This paper expands this perspective by linking firm value to relational exchanges outside the firm—with intra-industry partners.

The impact of top leadership on innovation and firm value is another hot topic within marketing. Research has shown that CEOs have a positive, direct, and long-term impact on innovation outcomes (Yadav et al. 2007). This study extends this research by exploring the corporate-level impact of board of directors on firm innovation. However, innovation alone does not create long-term firm value as “there is actually an innovation glut. The real shortage is profits” (Schrage 2000 p. 225). Market allocation of innovation must account for competitors’ activity in order to impact a firms’ long-term financial performance (Sorescu and Spanjol 2008). This study not only presents Power Blocs as a mechanism for increasing innovation with regard to the market and competitors, but also shows their impact on firm financial performance.

Finally, this study makes a contribution to the public policy literature. The impact of inter-organizational linkages at firms’ top-leadership levels has been a matter of policy interest since the turn of the century, and came to a head 1913 when U.S. Supreme Court Justice Louis Brandeis stated that they were contrary to the public interest when applied to both rival corporations and firms within a supply chain.

Applied to rival corporations, it tends to the suppression of competition and the violation of the Sherman law. Applied to corporations which deal with each other, it tends to disloyalty and to violation of the fundamental law that no man can serve two masters. In either event, it tends to inefficiency for it removes incentives and destroys soundness of judgment. It is undemocratic for it rejects the platform: A fair field and no favors—substituting the pull of privilege for the push of manhood. (Brandeis 1913)
This concern led to Congressional approval of the Clayton Act, section 9, which forbade any individual from holding a directorship in two competing companies. Since then, scholars in fields as diverse as sociology, economics, accounting, law, and management have studied the phenomenon. Despite the original prohibition, this study shows interlocks are still very much present today as industries from banking to utilities have been granted exemptions to the restrictions. This study extends current work and thinking about inter-organizational board linkages by showing that they can have positive benefits. Additionally, since some of these benefits are found to be enhanced by competition, much of the alarm over these linkages as anti-competitive tactics is called into question.

MANAGERIAL IMPLICATIONS

Firms are continually looking to improve relevant information flows on customers, competitors, and other market agents. Board member Power Blocs are one channel of gathering these information flows. Based upon this study, top managers should work to leverage the linkages of well-connected board members to improve firm decision making. Formal structures to improve the dissemination of board member information to firm decision makers should be constructed. Meetings between board members and innovation/R&D team leads and top business unit leaders may improve the flow of outside information beyond corporate leadership.

In addition, possible linkages with same-industry firms should be a consideration for future board position appointments. In addition to taking into consideration the potential information flows and asset accrual stemming from board member linkages when choosing board members, firms should encourage the formation of linkages by existing board members. The creation of new linkages with relevant market agents should be encouraged by managers as a means of leveraging their board members’ contribution to the firm.

Finally, existing board member linkages should be identified by management. While boards of directors are embedded in a very dense network of ties, managers may not be aware of some linkages. Through formal identification of board linkages to external organizations, managers can identify opportunities for collaboration and direct accrual of specific information.

PUBLIC POLICY IMPLICATIONS

This study’s implications for public policy are three-fold. First, it calls into question the dominant logic that board member interlocks are disproportionately beneficial to the largest, most oligopolistic firms within an industry. Our results show that firms engaged in stiffer competition benefited more from board member Power Blocs. Second, it makes clear the prevalence of board member interlocks in firms across industries; and calls out the growing, if hidden, prevalence of Congressionally-granted industry interlock exemptions. If a large proportion of industries are no longer bound by the rules restricting intra-industry interlocks, why do they still exist, and does the irregular application of these laws cause an unfair advantage for some firms? Third, if interlocks between firms lead to increased firm innovation (presumably benefiting customers), and improved firm financial value for the shareholders without increasing sales (which might suggest monopolistic advances), why are board member interlocks still viewed as corporate evils?

LIMITATIONS AND DIRECTIONS FOR FUTURE RESEARCH

The results and implications of this study must be viewed in light of its limitations. While we have examined the outcomes of Power Blocs, there is also a possibility of reverse causality or concurrent causality. While it is tempting to test for these effects, the longitudinal issues of strategy and Power Bloc formation make it very difficult. As Mizruichi (1996) points out, board linkages form over long periods of time and may last for decades. Even if we were to assume that the formation of board member Power Blocs was due to a firm strategy to link with well-performing firms, this aspect of strategy cannot be
disentangled from the overall firm strategy. Simply, other aspects of the strategy begun prior to, or during the Power Bloc formation may be wholly or partially responsible for company gains. Thus, firm outcomes cannot be linked solely to the formation of Power Blocs as a reverse causality argument entails that board member linkages are a portion of an overarching strategy. Consequently, this remains a limitation of much of the research on interlocking directorates.

The public nature of all firms in the sample is another limitation. While director information is difficult to find for non-public firms, additional research may illuminate how directors in private firms function. Researchers have also argued that it is also important to study board composition because variables such as the director’s functional background or number of years of board experience may impact strategic firm outcomes (e.g. Carter et al. 2003). Future research should include such demographic information. Further, research in additional industries would also be helpful in establishing the generalizability of the results.

Researchers interested in board of director ties could investigate the effects of Power Blocs when firms are family-controlled. Often family controlled firms utilize ILDs to seek outside information and perspectives while retaining family control (Mizruchi 1996). Thus, the impact of Power Blocs on innovation and other firm level outcomes may be magnified in family controlled firms. Similarly, it would also be useful to study how a vocal director within an industry Power Bloc network, may impact firm outcomes.

As corporate leadership looks to improve the creation of firm assets through board member external information flows, it is also important to investigate the impact of board size and connectedness. Managers may wish to improve access to information through increasing the number of board members, and thus the number of linkages. Alternatively, managers may focus on improving the linkages of existing board members. Research into the impact of quantity vs. quality of board members and their linkages should be studied. Might there be a cost to firms that have too many board members as the social aspect and opportunity for face-time and personal sharing of information and insights is diminished? Similarly, does the contribution of board members serving on many outside boards decrease as their time and attention is split many ways? Do firms suffer diminishing returns from board members or board member linkages?

CONCLUSION

This paper introduces Power Blocs as a tool to measure network ties and as a mechanism to grow coopetition between firms. While interlocking directorates have been historically viewed as a cause for concern, this study suggests that Power Blocs are beneficial for firms and do not lead to monopolistic effects. Further, their benefits increase when firms operate in more competitive industries, though their role diminishes in a turbulent environment.
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WHO NEEDS PEACE OF MIND AND AT WHAT PRICE: EXTENDED SERVICE CONTRACT WARRANTIES AND WILLINGNESS TO PAY

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Although Extended Service Contract warranties (ESC’s) are an important part of the marketing mix, there is little research on the underlying mechanisms that drive the consumer’s decision to purchase ESC’s. While prior research has suggested that personal factors such as risk aversion, gender, moral hazard, and income-level are significant predictors of ESC purchase, research in this vein is also very sparse and often contradictory. Furthermore, the scant literature on warranties has investigated neither how warranties should be priced (as a function of the consumer’s willingness to pay), nor how they should be presented to consumers.

In this paper, I will present the results from several studies which examine how consumers make decisions about purchasing ESC’s and how they should be optimally priced. To understand this process, I will conduct several studies which examine the effects of prevention/promotion focus, risk aversion, psychological reactance, risk aversion, type of ESC offered, and prior experience with ESC’s. The data will be analyzed using a willingness to pay (WTP) model, similar to that first articulated by Sinha et al (2009), which allows for the existence of individuals who have absolutely no intentions of ever purchasing a warranty, as well as for individuals who are rather high in their propensity to purchase a warranty. I also examine the potential impact that offering an ESC warranty has on brand equity. The paper then concludes with guidelines for how ESC’s should be priced and promoted to maximize profits for manufacturers and resellers.

‘Extended warranty? How can I lose?’
Homer Simpson, upon having his low IQ restored (S12E09)

INTRODUCTION

Extended Service Contract warranties (ESC’s) have become an important part of the consumer landscape over the last twenty years. There are several important reasons that this transformation has occurred: first, as product reliability has increased across most consumer product categories offering ESC’s has become less risky for firms (Lutz and Padmanabhan 1995); second, competition between manufacturers and retailers has made it necessary for firms to offer some sort of warranty coverage to prevent retailers from capturing a disproportionate amount of the resulting surplus (Lutz and Padmanabhan 1995; 1998); third, firms have used ESC’s as a means of reducing customer apprehension or uncertainty around the purchase of really new products (Boulding and Kirmani 1993). Although there is some degree of moral hazard for manufacturers to produce inferior products (Kessler 1943), competitive pressures across manufacturers has helped to sustain high levels of product reliability. This high level of quality has been particularly instrumental in driving the sales of ESC’s, because the risk for both manufacturers and retailers is extremely low when offering warranties to protect higher caliber products. As a result, these warranties have also become an important source of revenue and profit for big-box retailers in particular. For example, retailers Best Buy and Circuit City each earned more than half of their profits in 2003 from ESC’s, despite the fact that these ESC’s accounted for only 3-4% of their respective net revenues for the same time period (Business Week 2004; Washington Post 2006). Moreover, about $15 billion are generated annually from ESC’s, with roughly $8.3 billion of that total coming from sales of ESC’s for computers, electronics, and major appliances (Bloomberg 2009).

However, despite the popularity of these ESC warranties, there are still several important gaps in the research that need to be addressed in order to develop an approach to offering these ESC warranties in a manner that is both strategically sound and psychologically informed. Foremost, to the best of our
knowledge, no one has yet examined how these offerings impact perceptions of the brand, of the product purchased, or of the overall purchase experience. For example, do ESC warranties heighten the level of risk that is associated with a product purchase? Might they create a perception of risk, and therefore lowered expectations of the product’s reliability and performance? It is likely that this is the case for some consumers, thus undermining perceptions of the brand. This is an important question to address, because the interests of the retailers and the manufacturers are likely to be in opposition when retailers offer these warranties. Another important question, that has not been well examined, is that of what factors beyond risk aversion drive consumers to purchase ESC warranties. If consumers really are risk averse about a product purchase, why would they not just spend the extra money to purchase a better product rather than spending that same amount to induce a substandard manufacturer to provide a higher level of support?

This paper aims to address these questions through the development of a model that examines the effects of consumers’ risk-aversion, prevention/promotion framing of the warranty message, brand equity, and persuasion-knowledge on their willingness to pay (WTP) for ESC warranties. The paper is organized as follows: First, I will discuss previous research on warranties, then I will review the literature on risk-aversion, prevention/promotion focus, and other potential factors that would influence warranty purchase. Finally, I will introduce the preliminary findings obtained from a preliminary sample of 397 students, and discuss the potential implications that these findings might have.

BACKGROUND LITERATURE

Warranty Research

Despite the fact that the research on warranties is still relatively sparse, some consistent themes have emerged out of the warranty literature. For example, early research on warranties focused on the persuasive value of warranties in helping customers overcome their reluctance to purchase a new product when the product was in a relatively unfamiliar category (Perry and Perry 1976) or as a potential signal that the product was of high quality (Boulding and Kirmani 1993). Thus warranties are said to act as risk-reduction cues for consumers by providing assurance that the product would perform to expectations. However, research has also shown that factors such as the price and the reputation of the entity providing the warranty can also perform a similar risk-reduction role (Shimp and Bearden 1982). Other factors, such as increasing the length of the warranty time period, is a strategy that seems to allay the concerns of both expert and non-expert consumers alike (Blair and Innis 1996). This strategy also has the benefit of appealing to the non-expert customers in particular. For providers of ESC warranties, this is important because experts tend to be more critical of manufacturer claims and are more likely to be able to fully evaluate both the claims of the warranty provider and the intrinsic qualities of the product themselves (McKenzie and Lutz 1989). Because there tend to be fewer experts than non-experts in most product categories, this strategy has the benefit of appealing most to the consumers who might need the additional assurance. However, the use of warranties also presents somewhat of a moral hazard for expert customers, who can take advantage of these warranties knowing that they intend to use the product more heavily than the manufacturer might have intended. These findings suggest that an optimal strategy to firms might be to offer minimal warranty coverage, and then to price different levels of warranty coverage such that more cautious customers are simply paying extra to be over-insured, while high-usage customers are paying extra to obtain coverage that is commensurate with their higher degree of use.

In recent years, because of the increasing profit margins on extended warranties for retailers and manufacturers alike, the literature on warranties has tended to focus on the factors that drive consumers to purchase these warranties, as well as on the characteristics of those who choose to buy them. Given this trend, it is likely that there will continue to be a focus on the purchasers of these ESC warranties, about whom much is still unknown.
Risk-Aversion

Risk aversion has been consistently cited as one of the key drivers of the decision to purchase an ESC—this assumption is the cornerstone of the warranty literature. Essentially, all potential customers will have some degree of concern that the product they purchase from a manufacturer could malfunction. For many durable goods such as modern automobiles, computers, and televisions, most consumers are not capable of assessing the product beyond assessing the stated features of the product, or of determining the odds of any random product failure. As such, product quality is not directly observable by customers, and so there will always be at least some concern of product failure. This concern over product failure, or risk aversion, must be sufficiently high to induce the consumer to purchase the ESC warranty, but if the consumer becomes too risk averse, then the consumer essentially doubts the warrantor quality (Shimp and Bearden 1982) and refuses to purchase the ESC warranty. Thus, the relationship between WTP for an ESC warranty and risk aversion should resemble an inverted-U.

H1: Risk aversion will have a positive, curvilinear relationship with WTP for ESC warranties.

To the extent that consumers are risk averse, manufacturers need to focus on the potential cues that influence perceptions of product quality for lesser known brands. One potential signal of product quality is price, such that higher-priced goods are considered to be of higher quality relative to lower-priced products (Srinivasan 1991). Individuals will therefore tend to avoid lower-priced options in unfamiliar product categories. Although manufacturers can also signal quality through increasing the base warranties that they provide, (Blair and Innis 1996; Shimp and Bearden 1982), the fact that both sellers and manufacturers can provide optional ESC warranties, puts pressure on manufacturers to provide only minimal warranties in order to reduce the risk of customer moral hazard (Lutz and Padmanabhan 1995). Furthermore, the presence of third-party ESC warranties offered by retailers (rather than by manufacturers) can be used as a strategy to simultaneously reduce product quality and increase profits (Lutz and Padmanabhan 1998). Manufacturers employing this strategy would reduce the quality of goods aimed at lower-valued customers and de-bundle the basic warranty provided with the product, and instead making it optional for an additional cost. Because the manufacturing firm has an informational advantage as to the product’s reliability and performance, the manufacturer can optimally price its warranty offerings. Thus, there is also external pressure on manufacturers to price their offerings proportionally to quality, and to use price as a means of screening customers. This further increases the likelihood that consumers will use price as a quality signal. If price is indeed a signal of quality, then all things being equal, higher-priced products should be perceived as being higher-quality and thus less risky and less likely to need the support of a warranty. Therefore, consumers should be less likely to purchase an ESC warranty for higher-priced goods than for lower-priced goods in the same category.

H2: Assuming equivalent products, the higher-priced option will generate lower WTP for ESC warranties.

Prevention/Promotion Framing

Another important facet of the ESC warranty process is the message that is used to offer the warranty. Typically, these warranties are offered by retailers immediately after the product is purchased. However, no research has yet examined the potential impact of the ESC warranty message itself on willingness to pay for an ESC warranty. If we accept the tenet that risk-aversion is an integral part of the decision to purchase an ESC warranty, then messages that further underscore this potential risk should be more effective than messages that highlight the use or quality of the product. Self-regulation theory (Higgins 1997) has suggested that individuals can have two basic decision orientations, prevention focus or promotion focus. Individuals with a prevention focus tend to be more sensitive to making accurate decisions that minimize errors of commission (Crowe and Higgins 1997), and they tend to focus on avoiding negative outcomes. Promotion-focused individuals, on the other hand, tend to be more concerned with making errors of omission; thus they tend to focus on positive outcomes, such as
achieving personal growth and achieving their aspirations. Experimental research on regulatory theory has found that individuals tend to match their particular focus with their decision strategies (Liberman et al. 1999), and that they develop more favorable judgments about a brand when there is fit between their regulatory focus and their decision process (Wan et al. 2009). In line with the regulatory focus approach, firms selling ESC warranties can communicate either the value of the warranties in reducing negative outcomes with the product, or in enhancing the opportunity to have positive experiences with the product. Because risk aversion is surmised to be an important component of the decision to purchase warranties, messages that are congruent with a prevention focus should be more effective at convincing consumers to pay more for ESC warranties than those messages congruent with a promotion focus.

H3: WTP for ESC warranties will be higher for prevention messages than for promotion messages.

There is already strong support for the idea that people tend to value hedonic products more than they value utilitarian products (Dhar and Wertenbroch 2000). This preference for hedonic goods is revealed when consumers must make forfeiture choices, rather than when they make acquisition choices. That is, there is a greater endowment effect for hedonic goods than for utilitarian goods. On the other hand, when consumers make acquisition choices, they will tend to choose the utilitarian product over the hedonic one.

It was noted in an earlier hypothesis that if price were a signal of quality, then the likelihood of purchasing an ESC warranty would be lower for products that are more expensive. An alternate argument is that perhaps higher-cost goods will be valued more than inexpensive goods. This argument is rather straightforward, that consumers would fear losing an expensive good more than they would fear losing an inexpensive one. As such, if an ESC warranty were available, they would be more likely to purchase it for an expensive good. Consistent with this argument, experimental research from the insurance literature has found that there is a strong relationship between the value of an object and the likelihood of its being insured (Browne and Hoyt 2000). Because insuring a product is likely to result from imagining its loss, this is consistent with the idea that it is perhaps the forfeiture scenario that is motivating the decision to purchase insurance, rather than the value of the object itself. This idea is supported by research on counterfactual thinking, (Roese 1997), which suggests that controllable losses, or those that can be easily “undone” create more negative affect than uncontrollable losses. It is likely that the loss of hedonic goods would be more likely to generate more salient counterfactual thought than utilitarian goods, in part because utilitarian goods are simply used more and with some regularity. This idea is supported by research on self-construal priming: for example, Mandel (2003) found that when the interdependent self was activated, consumers were more likely to be financially risk-seeking in a product purchase but less likely to be risk-seeking socially. If we allow that hedonic goods are more likely to be used as part of social interaction, and thus to be used in an interdependent setting, then it stands to reason that that the failure of a hedonic good might present more potential for regret than the failure of a hedonic good.

Taken together, two related hypotheses emerge. The first is that consumers will prefer ESC warranties when they purchase hedonic goods. The second is that, because of the greater fear of loss with hedonic goods, along with the greater message congruence when a prevention message is presented with a hedonic purchase, WTP will be highest for ESC warranties for hedonic goods presented with a prevention, rather than a promotion, message.

H4a: WTP for ESC warranties will be higher for hedonic products than for utilitarian products.

H4b: There will be an interaction between message type and product type, such that WTP for ESC warranties will be higher for prevention messages paired with the hedonic product than with utilitarian products.
Another important question that has not been examined in the research literature is that of the impact of optional ESC warranties on perceptions of the product’s brand. In essence, because the offer of an ESC warranty will provide the basis for some random elaboration of product failure, the consumer’s choice of a product might be affected by the offer of a warranty. As noted earlier, while hedonic goods are more likely to be valued in forfeiture, utilitarian goods are valued more in acquisition. If we consider the purchase process of a product to be a choice task, then we would expect there to be more justification before the purchase of utilitarian goods. In part, this is because the decision process for utilitarian goods is more likely to be based on features rather than on benefits. This idea is consistent with findings such as those of Tversky, Sattath, and Slovic (1988) who found that individuals tend to prefer choices based on justifiable arguments. This is also supported by the findings of Bazerman et al (1998), which suggest that choice tasks cause more of a focus on the “should” aspects, which bolsters the selection of utilitarian options. Furthermore, research on decision-making suggests that individuals place more weight on factors that are easier to compare (Nowlis and Simonson 1998). This allows for more justification and evaluation of utilitarian products. Taken together, these findings provide convergent support to the idea that purchasers of utilitarian products will have likely evaluated their decisions more, and have provided more justification based on the features, the uses, and on the “should” aspects of these products. For example, when buying a laptop computer, the consumer would focus on features such as processing speed, screen size, memory capacity, and battery life. An offer of an ESC warranty that undermines these features undermines the elaboration and justification processes that led to the acquisition of the product in the first place. Thus, the consumer who purchases the ESC warranty does so because her level of risk-aversion around the purchase has been increased. For this risk-aversion to be heightened, the level of brand equity must therefore have been undermined. This leads to the next hypothesis, that ESC warranty offers will lower the perceptions of brand equity for utilitarian products.

H6a: The offer of ESC warranties will have a negative impact on perceptions of brand equity for utilitarian products, but not for hedonic products.

Although research has suggested that manufacturers should offer minimal warranty protection in order to prevent resellers from receiving a disproportionate amount of the ESC warranty market, it is unclear how the competing offers of manufacturers and retailers influence consumer perceptions. Consistent with the signaling literature (Soberman 2003), one would expect that consumers might feel that a minimal warranty, paired with the offer of an ESC warranty, would signal that the manufacturer anticipates problems with its products, or that perhaps the manufacturer is attempting to extract more profit from the consumer. On the other hand, the retailer does not risk undermining its own brand equity by making the offer, but can potentially harm the manufacturer’s brand equity. To a certain degree, the offer of the ESC warranty from the retailer might increase the consumer’s assessment of the retailer’s expertise. Additionally, retailer-based ESC warranties tend to be offered for products across many manufacturers at the same price, so there is no reason that the brand equity of the product would be undermined per se. However, the offering of an ESC warranty by the manufacturer would not seem to convey any positive information about the brand or the product to the consumer. To the extent that the offer of a warranty from the manufacturer creates risk aversion, the brand equity of the manufacturer will be undermined by an ESC warranty offering.

H6b: ESC warranties offered by the manufacturer will result in lower levels of brand equity for the product than will ESC warranties offered by the retailer.

One potentially important trait that has received considerable attention in consumer research is that of psychological reactance. Refined by Hong and Page (1989), this trait focuses on the degree to which an individual is likely to perceive the actions of others as creating a threat to their personal freedoms. Individuals who are higher in reactance tend to be less trusting, they tend to be more argumentative, and they are less likely to agree to requests without justification of some kind. As such, these individuals
might be the most likely to refuse to purchase an ESC warranty when it is offered. Because these individuals are also less likely to want to depend on others, it is also likely that they would not want to depend on either a manufacturer or a retailer to provide additional service. Instead, these individuals would be more likely to choose products that are less likely to threaten their independence—this is consistent with self-construal priming research as well (Mandel 2003), which suggests that consumers are less risk-seeking in the financial domain when their independent selves are activated.

**H7:** The individual’s level of psychological reactance will moderate the relationship of message type with brand equity and WTP for ESC warranties.

Finally, recent research on the use of regulatory focus and persuasion knowledge has found that individuals who have a prevention focus are more likely to use their persuasion knowledge when confronted with a moderately manipulative persuasion message (Kirmani and Zhu 2007). This research also suggests that the regulatory focus itself can “activate” persuasion knowledge. While past research has considered persuasion knowledge to be activated by the degree of processing, such as in the Elaboration Likelihood Model (Petty and Cacioppo 1986), this recent research suggests that persuasion knowledge may influence brand perceptions regardless of the level of processing. Thus, consumers who are higher in persuasion knowledge to begin with would be more likely to be less persuaded by ESC warranty offers when the message is delivered as a prevention message. However, there would likely be less of an effect on the perceptions of the brand when this message is delivered with a promotion focus.

**H8a:** Individuals who are higher in Persuasion Knowledge will be less likely to purchase ESC warranties.

**H8b:** There will be a significant interaction between Persuasion Knowledge and message-type, such that WTP will be lowest for individuals high in Persuasion Knowledge who are presented with a prevention-focused message.

**METHOD**

**Contingent Valuation Willingness to Pay (WTP) Model**

To estimate willingness to pay for the different ESC warranties, I used the Double Bound Contingent Valuation method. This approach has been used in resource economics, and has been used in the marketing literature as well (Sinha, Machado, and Sellman 2010; Sinha and Mandel 2008). In this method, participants are presented with a bid, and are asked if they would pay that amount. If the participants accept that bid, then they are presented with a higher bid; if the participants decline the bid, they are presented with a lower bid. This generates four possible contingencies: those who accept both bids (Yes-Yes), those who accept the first but not the second bid (Yes-No), those who refuse the first bid but accept a lower bid (No-Yes), and those who refuse both bids (No-No). Individuals who refuse both bids are then asked if they would be willing to pay anything at all for an extended warranty on the product, and individuals who accept both bids are asked for the maximum amount they would pay for an ESC warranty. Individuals who refuse both bids and whose WTP is zero are denoted as No-No-No.

**Individual Differences Variables**

**Risk-aversion**

Several scales were used to assess different aspects of consumer risk and risk aversion. To measure risk performance, defined as the perceived degree of performance risk associated with the products used as stimuli, I used the Risk (Performance) scale developed by Shimp and Bearden (1982). To measure risk aversion associated with product use, I used the Risk Aversion (Product Use) scale of Price and Ridgway (1983). To measure overall trait risk aversion, I developed a four-item Likert-type scale. In order to make
the survey as consistent as possible for the participants, all items across all dimensions were assessed using seven point Likert scales (or semantic differential scales).

**Hedonic/Utilitarian**

To assess the degree to which the products were considered to be hedonic or utilitarian, participants were asked what percentage of the time the product would be used for fun/relaxing activities, and what percentage of the time the product would be used for work/school related activities. Additionally, I used the Hedonic/Utilitarian scale developed by Dawar and Pillutla (2000) to measure the degree to which the products were considered either hedonic or utilitarian. This scale has two components, a utilitarian component and a hedonic component. It should be noted the lower scores on the utilitarian dimension indicate that the product is considered more utilitarian, while higher scores on the hedonic dimension indicate that the product is considered more hedonic.

**Other individual differences**

Psychological reactance was measured with the Hong Reactance Scale (1989). This is a 14-item scale with four factors. Given the widespread use of this scale as a unitary measure, it was decided to do the same in this study. Persuasion Knowledge was measured with the Persuasion Knowledge scale of Bearden, Hardesty, and Rose (2001). Means, standard deviations, and reliability for all of these scales are reported in Table 1. Examination of the scale reliability data led to the removal of the Risk Aversion (Product Use) scale, and the risk aversion scale was reduced to three items.

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*Lower numbers indicate more utilitarian

**Higher numbers indicate more hedonic**
Wave 1

Participants were students taking introductory-level marketing courses at a large university in the southwestern United States. Although demographic data were not obtained at the individual level, the pool of 409 participants for that particular week was 58% males and 42% females. From this larger pool, a total of 387 usable sets of responses was obtained; twelve surveys were not included because participants failed to follow instructions, making it impossible to categorize their responses. Participants were given a flyer that contained information about the product that they were to imagine having purchased, along with a brief dialogue that contained a warranty sales pitch with either a prevention or a promotion focus. The prevention-focused sales-pitch contained highlighted information stressing the potential for problems to occur, and the value of the warranty in preventing these negative outcomes. The promotion-focused sales pitch highlighted the value of the warranty in terms of it enabling the computer to continually provide benefits to the user. Finally, the sales-pitch detailed whether the ESC warranty came from the manufacturer or the retailer. The flyer also contained information about the price of the product. For laptop computers, the Hi and Lo price points were $750 and $1250 respectively; for televisions the Hi and Lo price points were $1000 and $1500. These price points were developed based on prices found at various consumer electronics websites, as well as on pilot data gathered from a convenience sample. Upon reading about the product and reading over the sales-pitch, participants were asked about their willingness to pay a specified price for an ESC warranty. An example of this is presented in the Appendix. Students were then asked to respond to survey items that measured the individual differences variables mentioned earlier. Following the completion of several distractor tasks, some participants completed another WTP task for the second product. The product order was counterbalanced to prevent any potential order effects.

Wave 2

The second wave of this project will consist of 900-1100 undergraduate students majoring in business at the same university as in Wave 1. These students will be shown a presentation that contains the same information and manipulations as used in Wave 1, with the exception of the Price and Ridgway (1983) scale, which will be omitted.

RESULTS

This section is currently under development—the data will be assessed using a WTP model similar to the model used in Sinha, Machado, and Sellman (2010). Due to the large sample size required for this analysis, results will be presented when they are available.

BRIEF DISCUSSION

The purpose of this paper was to examine some of the factors that lead consumers to purchase ESC warranties. While prior research has tended to focus on the demographic characteristics of consumers who have purchased ESC warranties, this paper has attempted to better understand some of the factors that might better explain why consumers purchase these warranties. In this vein, this paper would make a significant contribution to the extant literature. To date, no research has examined the effectiveness of messages when they are paired with incongruous motivations. For example, what initially compelled my research in this area was the purchase of a very reliable new car several years ago. While waiting for the paperwork, the dealer placed a circuit-board in my hands, along with a list that detailed the cost of different repairs. Then she told me how complicated modern cars were, and how expensive they are to repair, and strongly suggested I buy the extended warranty. I had specifically purchased this well-known brand’s hybrid to avoid this type of problem. Although the car has been relatively problem-free for almost six years, this experience has significantly undermined my relationship with the brand as well as my confidence in my purchase, and I will never purchase a car from them again. At the same time, I own an iMac computer, purchased an extended warranty for it on the spot, and have been glad that I have never had to take advantage of it. Hopefully this research will illuminate the seemingly contradictory decisions.
of this consumer, and help marketers develop ESC warranty messages that are beneficial to consumers, the brand, and that benefit the bottom line.
SELECTED REFERENCES


STORYTELLING BY THE SALES FORCE AND ITS EFFECT ON BUYER-SELLER RELATIONSHIPS

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ABSTRACT

Buyer-seller relationships remain a dominant theme in the marketing literature. Since the inception of this stream of research, authors have named communication as a critical element in building relationships. Storytelling plays a central role in human communication as evidenced by research in the humanities, psychology and management literatures. The paper details a literature review and field work combined to form themes relevant to storytelling, personal selling and buyer-seller relationship building. A model and set of propositions are derived as well.

Interviewer – “Have you ever strategically told a story to accomplish a purpose?”

Veteran Salesperson - “I think that is selling.”

Interest in buyer-seller relationships represents one of the important streams of research in the marketing literature over the past quarter of a century (Dwyer, Schurr, and Oh 1987; Morgan and Hunt 1994). Postulated outcomes from good relationships include expectation of continuity, word of mouth, customer loyalty, improved seller objective performance and cooperation (Palmatier et al. 2006). Communication skills help sellers develop both a business and a personal relationship with buyers (Crosby, Evans, and Cowles 1990). One important communication skill for managers and salespeople is storytelling (Boje 1991; McKee 2003). Humans find stories compelling in a way that a simple presentation of the facts often cannot match (McGregor and Holmes 1999).

Scientists postulate a pervasive role for stories in our cognitive and social functioning (Polkinghorne 1988; Schank 1990). Management researchers have examined functional storytelling as a way of handling change (Hерacleous and Barrett 2001), facilitating knowledge transfer (Connell, Klein, and Meyer 2004), enhancing leadership (Forster et al. 1999), and for its role in entrepreneurial endeavors (Lounsbury and Glynn 2001). In marketing, research on storytelling often centers around its use in advertising (Escalas and Stern 2003; Mattila 2000) or brands (Woodside, Sood, and Miller 2008). No stream of literature exists which investigates the functional use of storytelling in the personal selling environment.

The lack of inquiry into storytelling as even a tactical tool in selling, much less as a strategic tool, is an oversight. The functional storytelling described in the management literature, the largest existing literature in business research about storytelling, differs significantly from that used by salespeople. Thus, the management literature on storytelling may serve as an example but not as a direct guide for storytelling in sales.

The very rudimentary scientific knowledge about storytelling in the selling domain places research attempting to fill this gap in the exploratory phase. Topics at this stage of development often defy hypothesis formation and testing, so researchers frequently choose to employ qualitative methods of investigation in early inquiries (Bonoma 1985). In order to better understand the nature of buyer-seller relationship building through storytelling, combining a review of literature spanning the humanities, social sciences and business disciplines with depth interviews of both buyers and salespeople will provide a productive starting point. The results of this inquiry will provide material for theory building followed by hypothesis formation and testing in future research.
The paper is organized as follows. First, I review literature on stories from the humanities, psychology, management and marketing to both underline the important aspects of storytelling and to reveal some of the mechanisms presumed to drive storytelling. This is followed by a discussion of the methods used in the qualitative study. The literature then serves as a foundation for discussing the themes which emerged during the depth interviews conducted with and field observation of buyers and salespeople. A model and set of propositions follow. The paper concludes with managerial implications, limitations and future research.

WHAT STORIES ARE AND WHAT THEY DO

Experts from a variety of domains have not reached consensus on a definition of story, despite manifold attempts (cf. McGregor and Holmes 1999, p. 404). There is even an entire book devoted solely to the question (Leitch 1986). I will espouse a fairly open convention based on Leitch (1986): a story is a discourse relating causally linked events. To illustrate: “Yes, I do love horses - I took my daughter riding last weekend for the first time and she says she will buy a horse now,” passes as a story by this definition, albeit a short one. “I love horses, but not the really large ones,” is a disclosure, but not a story as it fails to link causal events. Those of a literary bent prefer deeper material containing character development and a complication along with its attending resolution (Martin 1986). These elements are not as common in a conversational story.

Stories serve as data reduction devices by portraying reality in a simplified way. Storytellers employ various devices such as common scripts to reduce the amount of information required for complete explication (Bettman 1979; Schank and Abelson 1977). Stories and story skeletons further serve as simplifying frameworks around which to organize the perception of the external world (Bruner 1986; Weick 1995). This reduces the overwhelming task of sorting and absorbing complex arrays of information. Research into jury decision making in felony trials has shown that a narrative story sequence represents the most persuasive way to order evidence for jurors (Pennington and Hastie 1992). People may mesh stories, both self-created and heard, into an amalgam through which to view the past, present and future. This serves as the raw material for self-image and our images of others such that, “We create a self that is whole and purposeful because it is embedded in a coherent and meaningful story (McAdams 1993, p. 91).”

The disclosure needed to form personal stories or self-narratives need not be strictly based on intimate social disclosure, as rapport can spring from task oriented mutual disclosures (Jacobs et al. 2001). Jacobs et al. (2001) demonstrated that in a sales setting, simple task oriented disclosures can be effective relationship building tools, particularly when the disclosures are reciprocal in nature. Scholars of sales have long asserted that mutual disclosure is an important part of the buyer-seller bond (Crosby, Evans, and Cowles 1990). Researchers in psychology have also demonstrated that disclosure of personal events can have a profound effect on relationships (Ensari and Miller 2002; Gable, Gonzaga, and Strachman 2006). Disclosures are often made via stories.

Management researchers credit storytelling with many uses. Executives navigating today’s turbulent markets find stories help them win buy-in from employees for needed change (Heracleous and Barrett 2001). The ability of stories to make information compact and memorable makes them ideal for knowledge transfer (Connell, Klein, and Meyer 2004). Those researching leadership see stories as a critical tool in the kit of any leader (Forster et al. 1999). Entrepreneurs often find that articulating their story is key to both capital acquisition and early success in the marketplace (Lounsbury and Glynn 2001). The extensive practitioner literature on storytelling details ways to build trust, build brands, instill values, motivate effort and spur collaboration among other goals (Denning 2005; Neuhauser 1993).

Another stream of research ties storytelling to persuasion via narrative transportation theory (Gerrig 1993; Green and Brock 2000). Persons are presumed to be transported to the world of the narrative where
they employ an aesthetic based narrative processing rather than paradigmatically oriented analytical processing (Gerrig 1994). Narrative processing leads to less critical evaluations of propositions due to lower negative cognitive response, increased realism of experience and greater affective response (Escalas 2007; Green and Brock 2000). All three of these mechanisms could prove useful in relationship development by storytelling. Transportation also factors into mental simulations in which persons imagine sometimes fanciful situations by combining past events, possible future events and alternate possible outcomes. This can lead to more positive appraisals of the likelihood of the imagined events occurring, improved attitudes and even actual behavior changes (Escalas 2004). Properly used, a salesperson’s stories that promote such daydreaming may have a positive effect on relationship building through the hearer’s thoughts about the tellers social network, inclusion of the teller in the hearer’s self-narrative, and the resulting reduction in uncertainty such familiarity can bring.

McGregor and Holmes (1999) work on storytelling and relationships suggests that two mechanisms are at work when we tell stories: one causes biased memory in favor of evidence consistent with the story, the second does not employ evidence memory but rather gains impetus from the gist or skeleton of the story and is used as a heuristic. Contrary to factual lists of information, stories have an easily encoded, holistic plausibility that lends credence to the associated truth claims. As time goes by, persons flesh out the story skeleton by retaining new information that is consistent with the story they have told or heard and discarding information that is not (Schank and Abelson 1995).

The foregoing discussion reveals several streams of research from different disciplines that highlight the potential link between relationship building and storytelling. They illustrate the importance storytelling has in our daily lives and organizations; particularly as we attempt to form opinions of our environment, ourselves and others.

**METHOD**

No research stream exists in marketing to delineate the functional use of storytelling by salespersons. The aforementioned practitioner and peer reviewed management literature can serve as a jumping off point. We may also harness the efforts of psychologists, findings from research in advertising, and guidelines from the humanities to form a basis for inquiry. Yet, the initial outline remains blurred and untested. Qualitative techniques may work well during conceptualization where current knowledge is insufficient to support hypotheses formation – particularly in areas which are difficult to quantify, dynamic, highly contextually dependent and socially complex (Bonomo 1985; Eisenhardt 1989). Storytelling embodies these research challenges (Boje 1991).

The intention of this research is to begin work toward a generalizable theory that would yield testable hypotheses, which means the qualitative method must be carefully chosen (Eisenhardt 1989). To accomplish this, I meld earlier ideas from the relevant literature with those expressed by practitioners during depth interviews and field observation. Others have blazed this trail. “We sought to develop a holistic framework that integrates insights from our fieldwork with existing literature (Workman, Homburg, and Gruner 1998, p. 26).” A review by Homburg, Workman, and Jensen (2000) of the qualitative work used between 1984 and 1999 in the Journal of Marketing and the Journal of Marketing Research resulted in further distillation of these qualitative techniques. Additional guidance in conducting qualitative research in a manner compatible with a positivist/realist epistemology comes from the extensive work in this vein by Miles and Huberman (1984, 1994).

To begin the field research, I interviewed 6 buyers and 1 purchasing manager (2 female and 5 male) from a privately owned, medium sized manufacturer of industrial equipment located in the central United States. Buyer informants were selected based on the likelihood that they had ongoing contact with multiple salespersons for the same item. The interviews lasted an average of 45 minutes and were conducted at the interviewees’ place of business by the author. After spending a few minutes on open
ended questions about their relationships with salespersons, the interviews became increasingly structured to ensure that I gathered information believed to be relevant to storytelling as determined in the literature search. The interviews were recorded and immediately transcribed. I conducted similar interviews with 11 salespersons and 1 sales manager (all male) of the firm who interacted with national accounts or supported dealers. There were 19 interviews overall at this firm. Additionally, a buyer and a sales manager (both male) from a family owned industrial and commercial supply house located in the central United States were interviewed using the same process. There were 21 interviews total. Finally, the researcher spent two 8 hour days observing customer calls with 2 salespeople (both male) from this last firm. During these observations, the salespeople called on a total of 26 buyers.

Comparison and reasoning played important roles in the iterative process of data reduction and the amalgamation of resulting themes. The method does not rely entirely on quantitative analysis of coding (Homburg, Workman, and Jensen 2000), which sometimes highlights frequency as a surrogate for importance. Rather, in addition to frequency of mention, I also considered the strength of the interviewees’ conviction and reasoning, and a judgment about his or her apparent experience and powers of observation in deciding how to weight comments. This involves frequently stepping back to ask, “What’s going on here (Miles and Huberman 1984, p. 27)?” The field observations served to double check that sentiments expressed in the interviews had a foundation in practice. This goes beyond a simple tabulation of codes and involves extrapolation of evidence in light of what is already known to form the big picture of storytelling during sales encounters.

THE INTERVIEWS

In this section, eight themes which emerged during the interviews are expounded. Though the themes are arranged roughly in order of emphasis that does not necessarily imply order of importance, particularly in any specific sales context. Each theme is followed by quotes from the interviewees which serve as exemplars for that theme’s origin. The names of all interviewees have been changed to protect their identity.

Stories are a powerful tool

Salespeople believed that stories provide a powerful communication tool applicable to many situations. They expressed confidence in the ability of stories to entertain, persuade and relax prospects and customers, even when told with only modest skill. They believed stories were very useful for establishing credibility. Buyers agreed that stories represent an acceptable and useful sales tool within the limits described below in succeeding themes.

A veteran salesperson thought stories were credibility builders as they gave empirical evidence of expertise.

I think stories are very important and they can give you credibility if you are talking business and you can share experience and validate your expertise about what you have done or seen and that has helped in our business a lot since we do a lot of different processes. (Larry)

Stories play a role for salespeople in explaining what is unique about their company or product that a buyer might relate to their own situation, like the company history.

Yes, because it comes up in conversation because they might say something like ‘how did you get the name _______’ and most want to know if we are a publicly traded company so I tell them ______ and give them a little background and to a lot of people that is big. (Manny)
Appropriate stories can be persuasive and build relationships

Both groups agreed that stories are compelling and help in building relationships, especially when they are definitely applicable to the hearer’s situation. So, for a success story to be deemed applicable, the buyer must be able to see themselves replicating the success.

A junior salesperson used personal stories to help build relationships by becoming embedded in the buyer’s personal narrative.

I think it helps cement the relationship, for example [I] was with a customer and we were talking about business and after that all wrapped up I asked him about his new baby, his favorite football team that was playing that weekend and that is how we ended and I think that helps cement that relationship. (Moe)

Stories are useful when problems arise

Another particular type of story involves an explanation of how a problem occurred. Salespeople apparently underestimate the power of a story when problems arise.

Two mid-career buyers summed up the general feeling among buyers that knowing is better than not knowing the root cause of a problem in that it helps to reduce uncertainty.

Well I think the explanation is important and the more you can learn about the issue the better you have with dealing with it and it could be something that we caused and maybe we can come to a mutual agreement. (Leo)

The explanation is very important, if you went to someone and said I have a problem with this part and they say trash it and we will credit you then they are not trying to find a solution. But someone with an explanation seems like they are trying to help you find a solution. (Joe)

Salespeople and buyers disagree on the primacy of personal relationships

Another key area of disagreement between salespeople and buyers was on the importance of the personal relationship versus the business relationship. Salespeople believed that the personal side of the relationship should come first chronologically and that it was generally more important overall. Buyers were even more adamant that the business relationship was crucial, as it was the entire point of the association.

One junior salesperson had a strong but not atypical view among salespeople as to whether the personal or the business relationship should come first.

For me it is absolutely personal [first]. (Martin)

One mid-career buyer put it bluntly when asked about the effect of a successful personal relationship he had with a favored salesperson.

As far as business decisions it really doesn’t have an effect on it, it is just making a connection or breaking the ice for conversations.

Yes I can be a business friend but I am going to make the decision not based upon the relationship but what is best for our company overall through the whole process. (Leo)
Stories must be relevant to the buyer

Buyers were quite adamant that for a story to be effective it must be clearly relevant to the buyer’s case. This is true of stories about products, customer success, company history or personal anecdotes. Salespeople seemed aware of this and often added that the story should be interesting to the buyer and that brevity substantially improves chances for successful storytelling.

A veteran salesperson brought the idea of appropriateness and relevance into sharp focus from a tactical viewpoint. Stories out of left field simply do not mesh with any existing schema and may require as much cognitive effort to incorporate as factual statements do.

Don’t bore the customer, don’t be too long, and always tune in on what they want to hear. Typically you are not in a position to tell a story until you know that customer and what they like to do. (Matt)

Icebreaker stories are common and accepted within limits

Salespeople said they sought to establish common ground through observation of personal items in the buyer’s office that would allow them to remark about a mutual interest. Buyers acknowledged awareness that this icebreaker story is a tactical tool but that they do not mind it within reasonable bounds.

Two mid-career buyers reflected the general attitude among buyers toward salespersons’ tactical efforts to find common ground at the beginning of an encounter.

Sure, it is just something to break the ice and to get into a business mode after that and they are trying to have a personal connection with you too. (Leo)

Yes I have seen that a lot, but granted we don’t take a lot of vendors to our desk, but when we did I did see that a lot. I don’t have a problem with it but I also know what it is. (Gert)

Story quality and storytelling ability affects how stories are receive

They may have curvilinear effects, becoming noticeably more powerful at higher levels. Salespeople feel high story quality and storytelling ability are very helpful but not absolutely necessary to experience benefits from telling stories. Buyers were more inclined to discount the effects of varying story quality or delivery skill, except perhaps at high levels. Both do agree that an exceptionally strong ability to tell a story can be an advantage in communication and buyers admitted it might make a salesperson more persuasive at times. The groups agreed that story content trumps storytelling style and that humorous stories are a good thing in measured quantities.

Speaking on story quality versus storytelling ability, one veteran salesperson thought story quality was more important.

I think the story is the most important thing but it [storytelling ability] can help emphasize the story if they are interesting and can present it well. (Curtis)

Stories can have negative effects

Stories can have a downside, particularly when they are interminable, irrelevant or irreverent. Buyers assert and salespeople seem conscious some topics are best eschewed with religion, sex and politics being specifically mentioned. Salespeople tried to steer clear of almost any sensitive topic with customers they did not know extremely well. Still, buyers mentioned cases where salespeople had crossed the line in
topic choice. Most salespeople indicated they had made mistakes in the past in choosing stories and felt that the reaction of the customer made it easy to see when this happens. One critical but unanswered question is how often salespeople commit a miscue without realizing it.

One junior salesperson claimed he always knew when he had erred in telling a story, and admitted he had done so more than once. Others agreed with his ideas on body language and some mentioned tone of voice.

Oh yes a 100%. If you can read body language at all you can tell unless they try to hold back their feelings. (Martin)

**HYPOTHESES DEVELOPMENT**

Figure 1 – Theoretical Model for Study 1

Aesthetically based narrative processing is holistic in nature versus the more piecemeal or “logico-scientific” orientation of analytical processing; narrative processing encapsulates the “particulars of experience” in that, “It deals with human or human-like intention and action and the vicissitudes and consequences that mark their course (Bruner 1986, p. 13).” That is, narrative processing allows people to operate and make decisions, often by the construction of causal models and heuristics, in a world fraught with ambiguity, vagueness, uncertainty and a general lack of information (Robinson and Hawpe 1986). We use stories to grasp the big picture.

In interpreting stories through narrative processing, we thus have a tendency to think holistically rather than to conduct a piecemeal evaluation of each statement as typically occurs in evaluation of a list or argument via analytical processing (Adaval and Wyer 1998). Such holistic narrative processing may produce the reduced counter arguing postulated by narrative transportation theorists (Escalas 2004). Narrative processing of stories seemingly accepts the bounded rationality of human cognition, constructs the most plausible inferences from available information, at least partially discounts some contradictory evidence, and finally produces a reduced narrative or story gist that can then be used in forming heuristics.
and direct decision making (Bruner 1986; McGregor and Holmes 1999; Gerrig 1993). Arguments on the other hand lack the contextual aspects and assertions of causality in stories that are grist for the narrative processing mill, and so customers have little recourse when presented with an argument than to resort to analytical processing (Zukier 1986).

**H 1:** A sales pitch in story form will promote narrative processing, while a sales pitch in argument form will promote analytical processing.

From a tactical perspective, there are good reasons why salespeople may prefer to rely on the holistic or narrative processing promoted by a story. Our internal personal narratives and orientations are best accessed by other narratives (McAdams 1993).

Personal disclosures are a type of sales communication that is typically performed with a story. Sales researchers have long felt that mutual disclosure is vital to the buyer-seller bond (Crosby, Evans, and Cowles 1990). Narrative processing of stories makes them memorable and effective in eliciting reciprocation of disclosure by the hearer (Boje 1991). Sharing stories allows us to build personal bonds by vicariously experiencing events that actually happened to someone else and incorporating them into our own self-narrative and our narratives about others (McAdams 1993).

Salespeople reveal crucial facts about their values and behavior when telling stories to customers. Ahearne, Jelinek, and Jones (2007) model information communication as a key salesperson service behavior. They also point out expression of diligence, sportsmanship and empathy by the salesperson. The salesperson can subtly relate instances when they exhibited these values in the past through stories about other transactions with customers or personal events, whereas simply proclaiming oneself to be diligent, a good sport or empathetic in a factual statement makes for a rather awkward and relatively unpersuasive statement (Escalas 2004). Narrative processing promotes evaluation of personal accomplishments and characteristics in a manner that forms a ‘good story’ rather than one that clings to the logical rules of analytical processing (Zukier 1986).

McGregor and Holmes (1999) suggested first, stories cause biased memory in favor of information consistent with the story and second, story skeletons can form the basis for heuristics hearers then use for decision making. Narrative processing thus presents a powerful tool for encoding and decoding information in a persuasion context. Hearers even accept some puffery or poetic license in stories told in persuasive settings like politics and sales without harsh evaluation (Green and Brock 2000). This is why narrative transportation theory asserts that storytelling can flexibly address the subtleties inherent in communication during persuasion attempts (Friestad and Wright 1994).

**H 2a:** A salesperson will be higher under narrative processing than under analytical processing.

The foregoing arguments about the memorability and persuasiveness of stories and their resulting narrative processing also apply to the effect of type of processing on the attitude toward the product (Escalas 2007). The potential customer’s questions often concern product benefits. In providing information about product attributes and benefits, stories can again prove less socially awkward and appear less like braggadocio than arguments as they relate actual events instead of performance claims. The causality inferred during narrative processing of stories can also assist in tying product attributes to the resulting benefits in a more convincing way than analytical processing so customers readily believe they will actually enjoy the product benefits extolled by the salesperson.

**H 2b:** A product will be higher under narrative processing than under analytical processing.
A fundamental assumption in personal selling is that it is better to accentuate the positive and downplay the negative, so much so that salespeople have a reputation for being occasionally disingenuous in their pursuit of persuasion (Cialdini 2007). But stories may provide a way to divulge less than desirable features without creating problems. The narrative processing promoted by stories leads us to final interpretations that are cohesive. This leads to an interesting outcome in that we adjust stories we hear so they are retained in memory as a coherent whole; or as Schank and Abelson (1995, p. 43) says, “Memory tends to lose the original and keep the copy.” Thus, information that is difficult to reconcile with the story may be discarded. One result of this rejiggering of the facts is that narrative processing of stories may have the power to smooth over undesirable features better than analytical processing of arguments.

In examining this effect, Adaval and Wyer (1998, p. 211) based a study on the following. First, they believed that people may simply not include inconsistent information in the story gist or “narrative representation” they retain from narrative processing. This would greatly lower the accessibility of the inconsistent information when they employ the narrative representation in decision making (Kahneman 2003). Second, people may interpret any inconsistent information that is retained differently in its natural context within the story. This contrasts with evidence that undesirable traits are typically weighted more heavily than desirable ones in analytical processing of a list or argument (Skowronsksi and Carlston 1989). When the disclosure of undesirable features occurs during a story and results in narrative processing, the hearer may judge them less harshly than if the same information were divulged in an argument and processed analytically.

H3a: The effect of analytical versus narrative processing on A_{salesperson} will be moderated by the presence of undesirable features in the sales pitch. The difference between the effect of analytical and narrative processing on A_{salesperson} will be greater when there are some undesirable features than when there are none.

Narrative reduction of stories commonly plays a role in heuristic formation. McGregor and Holmes (1999) believed heuristics formed from story gists serve as important decision making tools for those who have heard a story. Consumer behavior researchers found that with heuristics, “This type of constructive processing is opportunistic (Hayes-Roth and Hayes-Roth 1979) and may occur when consumers notice characteristics of the information which can be exploited, such as patterns of covariation (Coupey 1994, p. 85).” The causality revealed by narrative processing of a story rather than analytical processing of an argument assists the customer in seeing patterns like covariation. Coupey (1994, p. 84) states, “The end result of a restructuring process is the creation of a new information display, which may then serve as the basis for evaluation of brands or products.”

The mechanisms of consolidating only coherent information into the retained narrative representation and holistic interpretation of whatever contradictory evidence is retained will operate in determining A_{product}, perhaps through a heuristic derived from narrative processing.

H3b: The effect of analytical versus narrative processing on A_{product} will be moderated by the presence of undesirable features in the sales pitch. The difference between the effect of analytical versus narrative processing on A_{product} will be greater when there are some undesirable features than when there are none.

DeCarlo (2005) modeled a link between attitude toward the salesperson and purchase intentions in a study of suspicion of ulterior motives and salesperson tactics. Relying on the work of Ajzen and Fishbein (1980) and Petty and Cacioppo (1986a) to develop their hypothesis, they found a significant relationship. As is the case for favorable attitudes toward the product, favorable attitudes towards the salesperson should positively influence the customers purchase intentions.
In linking attitudes to purchase intentions, researchers following Ajzen and Fishbein (1975, 1980) rely on the beliefs→attitudes→intentions→behavior psychological model of behavior and accept, “... that the most immediate precursor of behavioral intention is attitude...” (Oliver 1980, p. 461). Attitudes are general evaluations of the attitude object and may have a behavioral, affective or cognitive base – as such they, “... are capable of influencing or guiding behavioral, affective, and cognitive processes (Petty and Cacioppo 1986b, p. 127).” Thus, attitudes are presumed to impact behavioral intentions.

H 4: Attitude toward the salesperson and the product will be positively related to purchase intentions of the customer.

Figure 2 – {expected} Results of study 1 for $A_{\text{salesperson}}$ and $A_{\text{product}}$

![Diagram showing expected results of study 1 for $A_{\text{salesperson}}$ and $A_{\text{product}}$](image)

Both $A_{\text{salesperson}}$ and $A_{\text{product}}$ will be greater under narrative processing than under analytical processing, and even more so when there are some undesirable features in the sales pitch.

Managerial Implications, Limitations and Future Research

The foregoing discussion demonstrates that stories can be important in relationship building and suggests storytelling can be improved through conscious effort. Managers and salespeople should benefit from becoming students of storytelling much as they can from more traditional sales training in prospecting, asking questions or negotiation skills. Drawing attention to the phenomenon of relationship building via storytelling may help managers and sales personnel improve relationship building efforts with little or no additional cost. Training in storytelling is lacking, however. Neither buyers nor sellers had received significant training on how to tell or interpret stories.

From the outset I have stated that the investigation of storytelling in sales is in its infancy. No doubt salespeople from time immemorial have consciously and unconsciously used stories to increase familiarity, reduce perceived risk and build relationships. Yet the scientific inquiry into this ubiquitous practice from a tactical and strategic viewpoint is only beginning. The current study is thus necessarily
modest in scope and ambition, attempting only to uncover some important themes and suggest ways to integrate these themes with current research models with an indication of future research possibilities.
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CELEBRITY ENDORSEMENTS AND ADVERTISING EFFECTIVENESS: 
THE IMPORTANCE OF VALUE CONGRUENCE

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A number of companies use celebrities in advertisements to promote different kinds of products. Indeed, millions of dollars are spent on celebrity contracts each year by assuming that the benefits of using celebrities will exceed the costs. Given the popularity and importance of celebrity endorsements, the impact of celebrity endorsements on advertising effectiveness has been studied extensively over the last 30 years. For instance, to measure the effectiveness of advertisements with celebrities, different levels of hierarchy of effects models (i.e., cognitive level such as brand recall, affective level such as attitudes toward ad, and conative level such as purchase intentions) have been used as dependent variables. Source variables, i.e., credibility (expertise and trustworthiness) and attractiveness (familiarity, similarity, and likeability) (e.g., McGuire 1969), on the other hand, have been used by many researchers to understand the impact of celebrity endorsements on those dependent variables. However, the underlying mechanisms used to explain the impact of those source variables on the relationship between celebrity endorsement and advertising effectiveness fail to converge.

One of the theories used frequently by researchers to explain the impact of celebrity endorsements is the match-up hypothesis. This theory suggests that there should be a good fit between the celebrity and the product; however, it is not clear what constitutes a good fit. Some researchers have focused on the attractiveness dimension and suggested that attractive celebrities will be more effective if they are used to promote attractiveness-related products, such as razors or perfume (e.g., Kahle and Homer 1985; Kamins 1990). Other researchers focused on the expertise, or product relatedness, dimension. They claimed that when there is congruency between the product type and the celebrity (as in the case of a sports athlete promoting sports shoes), advertising effectiveness will be enhanced (e.g., Till and Busler 2000). The purpose of this study is to introduce another dimension, i.e., social values, to increase the effectiveness of the match-up hypothesis.

This paper is organized as follows: First, a review of relevant literature will be provided. Then, based on the literature, hypotheses will be formulated. Next, results of a series of experiments will be discussed. Finally, ideas for future studies will be proposed and limitations of the studies will be discussed.

**LITERATURE REVIEW**

**Source Effectiveness**

Years of research on attitude formation and attitude change revealed several factors that influence the effectiveness of a communication, such as the reputation of the communicator and of the medium that the communicator employs, the receptivity and predispositions of the audience, the actual content of the message, and matters of organization and procedure (Hovland 1957). In Laswell’s (1948, pg. 117) terms, the study of attitude change boils down to the question, “Who says what to whom in what context?” From this question, variables having an impact on attitude change have traditionally been organized into source, message, recipient, and context categories. Because this research considers the issues related to celebrity endorsements in advertising, only source variables, or attributes, will be examined in detail. Source attributes refer to the aspects of the persons or groups presenting the persuasive appeal. These attributes are usually categorized into two groups: credibility (i.e., expertise and trustworthiness) and attractiveness (familiarity, likeability, and similarity) (e.g., McGuire 1969).

Source credibility is concerned with how a person’s perceptions of “the expertise or the objectivity of the source guides him/her in seeking the “truth” of a particular persuasive communication” (Percy
Therefore, according to the source credibility model, credibility has two components. The first component, called expertise, deals with how knowledgeable the source is on the subject of the advertising message, whereas the second component, called trustworthiness, refers to the willingness of the source to discuss the subject of the advertising message honestly. It is argued that experts “are effective because communications attributed to an expert endorser produce greater agreement with the subject than the same communications attributed to a nonexpert” (Biswas, Biswas, and Das 2006, pg. 19). Studies conducted by social psychologists and marketing researchers over the last 60 years showed that sources with high credibility are perceived as more persuasive than sources with low credibility (e.g., McGuire 1969). Feick and Higie (1992), for instance, provided evidence for the positive impact of expertise on the attitudes and intentions for the lower preference heterogeneity services (i.e., services that are characterized by little variation in consumers’ tastes and preferences). Biswas, Biswas, and Das (2006) showed that for high-tech products, expert endorsers were more effective than celebrity endorsers in reducing customer risk perceptions.

McGuire (1969) suggested, based on the source attractiveness model, that attractiveness is composed of three interrelated aspects: familiarity (knowledge of the source), similarity (resemblance between the source and the receiver of the message), and likeability (affection for the source, usually as a result of physical attractiveness) (Biswas, Biswas, and Das 2006). Therefore, when message receivers (consumers in a marketing context) are familiar with the source, like the source, and find similarities between the source and themselves, the messages become more persuasive (McGuire 1969). Snyder and Rothbart (1971) have found that listening to a message in the presence of a photograph of an attractive male source was more persuasive than listening to the same message in the presence of a photograph of an unattractive source or no visual cue at all. Baker and Churchill (1977) conducted an experiment in two product categories (i.e., coffee and cologne/perfume/aftershave) and found that physical attractiveness of the models used in the ads increased the affective evaluations (e.g., appealing, interesting, impressive) of the ads but not the cognitive evaluations (e.g., believable, informative). They also showed that cologne/perfume/aftershave ads were more effective in creating behavioral intentions for males when attractive female models were depicted in the ads. DeBono and Telesca (1990) showed some participants a slide of a woman who was both beautiful and darkly tanned. Other subjects saw the same woman, but her dress and hairstyle were altered so that she was quite unattractive. Each picture was accompanied by one of two audio tracks that delivered either a strong persuasive message or a weak persuasive message for new tanning oil. The results indicated that the attractive source led to better recall and more positive attitudes when the message was strong. With weak messages, on the other hand, attractiveness did not make a significant difference. Some other studies, however, did not find a significant effect of attractiveness. For instance, Maddox and Rogers (1980) showed that physical attractiveness has no effect on persuasion, suggesting that under some conditions attractive sources may need to possess expertise or provide supportive argumentation to persuade the message receiver. Caballero and Solomon (1984) did not find any effect of source attractiveness in producing sales of beer (high involvement product). They found a significant effect of attractiveness in sales of tissue, but in the opposite direction: low attractiveness led to more sales.

**Celebrity Endorsements**

Because credibility and attractiveness play an important role to improve the persuasiveness of a message, companies try to find sources that satisfy these two criteria (i.e., credibility and attractiveness) to present their messages to customers (Kahle and Kahle 2006). One of the sources used frequently in marketing, specifically in advertisements, is celebrities. A celebrity endorser is defined as “any individual who enjoys public recognition and who uses this recognition on behalf of a consumer good by appearing with it in an advertisement” (McCracken 1989, pg. 310).

Because celebrity endorsement has become one of the most prevalent forms of advertising globally, several studies have examined the effectiveness of celebrity endorsements in advertising. For instance,
Friedman and Friedman (1979) showed that celebrities have significant effects on attitudes toward the product and purchase intentions when they endorse products high in psychological or social risk, such as costume jewelry. They also found that celebrities are more effective than expert or typical-consumer endorsers in advertisement recall and brand name recall, regardless of the product type. Kamins (1989) and Kamins, Brand, Hoeke, and Moe (1989) showed that brand attitudes and purchase intentions were affected positively by celebrity appeals. They also showed that the two-sided celebrity appeal performed best and the one-sided noncelebrity appeal performed worst in terms of attitudes toward the brand and purchase intentions. Ohanian (1991) provided evidence for the effect of perceived expertise of the celebrity on purchase intentions by using four different celebrities. Tripp, Jensen, and Carlson (1994) examined the effects of multiple product endorsements by celebrities and found that the number of products a celebrity endorses had a negative impact on consumers’ perceptions of celebrity credibility, celebrity likeability, and attitude toward the ad. Bush, Martin, and Bush (2004) showed that celebrity sports athletes have a positive significant impact on adolescents’ word-of-mouth intentions and brand loyalty. They also found that female teenagers’ word-of-mouth intentions are more affected by female celebrities than male celebrities, and female teenagers agree more than male teenagers that they are effected by celebrities in buying certain brands.

While most studies focused on the consumers’ responses to celebrity endorsement, Agrawal and Kamakura (1995) assessed the economic value, or profitability, of these endorsements. They suggested that when a celebrity endorsement contract is announced, investors evaluate the future profit impact of the contract, and these evaluations are reflected in the companies’ stock returns. To test for their proposition, Agrawal and Kamakura (1995) analyzed announcements of 110 celebrity endorsement contracts between January 1980 and December 1992 by using event study methodology. Their findings showed that “on average, the impact of these announcements on stock returns is positive and suggest that celebrity endorsement contracts are generally viewed as a worthwhile investment in advertising.” (Agrawal and Kamakura 1995, pg. 56). Similarly, Mathur, Mathur, and Rangan (1997) used event study methodology to show that “anticipation of Jordan's return to the NBA, and the related increased visibility for him, resulted in an average increase in the market-adjusted values of his client firms of almost 2 percent, or more than $1 billion in stock market value” (pg. 67).

Even though effects of celebrity endorsements have been studied for years, the findings fail to converge in terms of the underlying mechanisms used to explain the relationship between celebrity endorsement and advertising effectiveness. For instance, Kelman (1961) claimed, by referring to source attractiveness model, that celebrity endorsement leads to changes in attitudes of consumers through an identification process, in which consumers establish an identity associated with the celebrity. Mowen (1980) used the attribution theory to suggest that effectiveness of celebrity endorsements depends on the consumers’ willingness to understand the causal reasons for a celebrity to endorse a product: if consumers think that the celebrity endorses the product because of the characteristics of the product, instead of some monetary incentives, then the celebrity endorsement will be more effective. Some researchers applied the associative learning theory (Collins and Loftus 1975) to celebrity endorsement studies by claiming that celebrities and brands that represent nodes in memory are linked together over time through endorsement processes. Specifically, feelings and meanings associated with the celebrity are transferred to endorsed brands, and this transfer leads to simultaneous activation of memory nodes (Biswas, Biswas, and Das 2006; Till and Busler 2000). Similarly, McCracken (1989) suggested that celebrities bring their own symbolic meanings to the endorsement process and through this process, cultural meanings residing in the celebrities pass to the products. Then, according to the meaning transfer model, these meanings are transferred from products to consumers. Carlson and Donavan (2008), by using the social identity theory (Tajfel and Turner 1985), claimed that when consumers’ identification with the sports athlete celebrity is high, their attitudes toward the team and their intentions to purchase the endorsed product are also high. Elaboration Likelihood Model (ELM) was also used to explain celebrity endorsement effects by suggesting that a celebrity endorser acts as a peripheral cue for low-involved customers (e.g., Petty,
Cacioppo, and Schumann 1983). Some other researchers, however, claimed that celebrities can provide central information when there is congruency between celebrities and products endorsed (the match-up hypothesis; e.g., Kahle and Homer 1985).

**The Match-Up Hypothesis**

The match-up hypothesis suggests, “endorsers are more effective when there is a fit between the endorser and the endorsed product” (Till and Busler 2000, pg. 1). Most studies approached this “fit,” or “match-up,” from attractiveness or expertise perspective. For attractiveness, it has been claimed that attractive endorsers are more effective when endorsing products that are used to enhance attractiveness. Similarly, it has been suggested that celebrities are more effective when endorsing products that are related to their professions because those celebrities are perceived as experts by consumers. For instance, the match-up hypothesis suggests that sports athletes should be used to endorse sports-related products.

Kahle and Homer (1985) integrated the match-up hypothesis with the Social Adaptation Theory (SAT) (Kahle 1996; Kahle and Timmer 1983). The SAT assumes that the impact of any information depends on the adaptive significance of the information. In other words, as long as the information provides usefulness for the adaptation, or facilitates adaptation, the receiver will process it. It is also assumed that “information is processed in fundamentally the same way for both high and low involvement; however, information processing ends more quickly for low involvement products” (Kahle and Homer 1985, pg. 955). Because the type and quality of the information are important for the SAT, the match-up hypothesis is perceived as a legitimate theory to explain celebrity endorsement effect (Kahle and Homer 1985). For instance, it is assumed that if attractiveness provides the most relevant product-related information, then it should have a significant main effect on attitudes. To test the integrative effects of SAT and the match-up hypothesis, Kahle and Homer (1985) replicated the study conducted by Petty, Cacioppo, and Schumann (1983). Specifically, they asked participants to examine eleven real magazine ads and one experimental ad that included one male and one female celebrity and a product that could be used to enhance attractiveness, i.e., razor. The experimental ad was used to manipulate the attractiveness and likeability of celebrities. The results showed that when there was a good match between the celebrities and the product, then brand recall, arguments recall, attitude toward the product, and intentions to buy the product were higher. In other words, attractive celebrities were more effective because attractiveness provided central information regarding the product that was used to enhance attractiveness.

Similar to Kahle and Homer (1985), Kamins (1990) argued that using an attractive celebrity in the advertisement provides adaptive information because it might make customers to think that the brand endorsed by a celebrity will enhance their attractiveness as it did for the celebrity. Indeed, he showed that an attractive celebrity had significant effects on spokesperson credibility and attitude toward the ad for an attractiveness-related product, but had no effect on the same measures for an attractiveness-unrelated product.

Till and Busler (2000) examined two match-up dimensions: attractiveness and expertise. In their first experiment, they manipulated physical attractiveness and product type. Although they found a main effect of attractiveness on brand attitudes and purchase intentions, they did not find a significant interaction effect on the same measures. In the second experiment, Till and Busler (2000) manipulated the expertise of the celebrity and product type. Their findings showed that a match-up between the celebrity and the product type (e.g., an athlete endorsing an energy bar) led to greater attitude toward the brand but not purchase intentions. In other words, they did not find a match-up effect for attractiveness but they found a match-up effect for expertise for brand attitudes.

Boyd and Shank (2004) showed that when there is a fit between the celebrity and consumer in terms of gender, consumers perceive the celebrity as more trustworthy, regardless of the product type endorsed
by the celebrity; however, consumers’ rate of expertise depends on the interaction between the celebrity, consumer, and product. Specifically, “women rate endorsers as more expert when there is a fit between the endorser and product (e.g., when the endorser uses the product in their sport) while men rate endorsers as more expert when there is not an endorser-product match,” (Boyd and Shank 2004, pg. 82)

Biswas, Biswas, and Das (2006) showed that when there is low congruency between the celebrity and product, expert endorsers are more effective than celebrity endorsers in reducing consumer risk perception for high-tech products; however, when the congruency between the celebrity and product is high, the differential effects of expert vs. celebrity endorsers for consumer perceptions of risks disappear.

Some researchers, however, have found greater persuasiveness when there is incongruence between the spokesperson and product. For instance, Lee and Thorson (2008) argued that different degrees of congruency might have different impacts on the effectiveness of celebrity endorsement. By using schema congruity, “the extent to which new information conforms to consumer expectations based on previously defined category schemas in memory” (Lee and Thorson 2008, pg. 435), they argued that resolving moderate incongruity between the celebrity and product might be rewarding, worthwhile, and interesting for consumers because of the curiosity prompted by the moderate level of unexpectedness; however, their studies provided mix results. Specifically, they found that attitude toward the brand in the moderately incongruent condition was significantly higher than that extremely incongruent condition but not significantly different from extremely congruent condition. Purchase intentions for moderately incongruent condition were significantly higher than in extreme conditions. Finally, there was no significant difference between congruency levels in terms of attitude toward brand.

Social Values

Rokeach (1968/1969, pg. 550) defined social values as “centrally held, enduring beliefs which guide actions and judgments across specific situations and beyond immediate goals to more ultimate ends or states of existence.” From Rokeach’s perspective, values are standards to serve many purposes in daily life. Similarly, Schwartz (1994) defines values as desirable transsituational goals that serve as guiding principles in the life, and their importance is different for each individual. In fact, values are described as the most important construct by many researchers (e.g., Rokeach 1973) in social science. They are central to people’s lives (Kahle and Timmer 1983), are enduring and difficult to change (Rokeach 1973), and guide behaviors and judgments across specific situations (Rokeach 1973; Kahle and Timmer 1983). In other words, values serve several functions for people. For instance, values define who we are (Rokeach 1973) and help us to differentiate ourselves from others (Kahle and Timmer 1983). In a way, they convey what is important to us in our lives (Steenhaut and Kenhove 2006). Values also influence the adaptation to life. Social adaptation theory (Kahle 1996) suggests that value development and value fulfillment effect the ways individuals adapt to various life roles. For instance, people who value warm relationships with others may try hard to make friends and have good relationship with their friends, but people who value self-respect most may try to improve themselves continuously. Moreover, values motivate and guide our behaviors (Kahle and Timmer 1983). In fact, it has been shown that values guide several aspects of human life, including political attitudes (Lee 2003), moral reasoning (Abdolmohammadi and Baker 2006), employee creative behavior (Rice 2006), and healthy lifestyles (Divine and Lepisto 2005).

Values also have been found to affect various aspects of consumer behaviors. For instance, gift-giving behaviors are more common for people who endorse self-respect and warm relationships with others (Beatty, Kahle, and Homer 1991). Shim and Eastlick (1998) found that self-actualizing and social affiliation values influenced attitudes toward regional shopping malls. A study conducted by groups of English and Indian people living in the UK revealed the effects of personal values on the consumption of Indian foods (White and Kokotsaki 2004). Limon, Kahle, and Orth (2009) showed that personal values enhance the perception of brand values and these brand values are inferred from product package designs. Other studies found a relationship between values and cynicism (e.g. Boush, Kim, Kahle, and Batra
Research on consumer means-end chains (MEC; e.g., Gutman, 1982; Reynolds, 1985) also revealed the importance of values in product/brand choice by showing that consumers select products to facilitate the achievement of desired end states, like happiness and success. Specifically, MEC theory suggests that “consumers use a cognitive chain for buying decisions that relates product attributes to benefits, which in turn contribute to fulfill personal values,” (Huber, Beckmann, and Herrmann 2004, pg. 715). For instance, Reynolds, Gengler, and Howard (1995) found that the strength of association between MEC elements, i.e., attributes-consequences linkage and consequences-values linkage, improved the brand persuasion of soft drink TV commercials. Mort and Rose (2004), however, showed that while attributes-consequences-values linkage, i.e., MEC theory, held for utilitarian products, attributes-values linkage held for hedonic products. In other words, for utilitarian products, there is an indirect relationship between attributes and values and consequences of attributes mediate this relationship. For hedonic products, on the other hand, there is a direct relationship between attributes and values. All these studies suggest that values influence product/brand choices as well as other consumer behaviors.

Values have been categorized in several ways. Rokeach (1968/1969), for instance, differentiated between instrumental (e.g., honesty, open-mindedness, and responsibility) and terminal values (e.g., a world at peace, equality, and inner harmony). Based on Rokeach’s (1968/1969) terminal values, Schwartz and Boehnke (2004) suggested four dimensions for values: openness to change (e.g., self-direction and stimulation), self-transcendence (e.g., universalism and benevolence), conservation (e.g., tradition and conformity), and self-enhancement (e.g., achievement and power). Homer and Kahle (1988), on the other hand, suggested that values fall into three dimensions: internal, external, and fun/excitement. Internal values reflect the belief that people can fulfill their values by themselves and include self-fulfilling, a sense of accomplishment, and self-respect. On the contrary, external values reflect the belief that people are dependent on others to fulfill their values. Being well-respected, sense of belonging and security are included in this dimension. The last dimension, interpersonal values, has an internal motivation to fulfill with others and include excitement, fun and enjoyment in life, and warm relationships with others.

HYPOTHESES FORMULATION

The purpose of this research is to better understand what constitutes a good fit between the celebrity and the product endorsed by the celebrity by introducing another dimension for the match-up hypothesis: social values. Because values are higher-order constructs that can affect other consumer-related constructs, such as consumer attitudes and behaviors, it is important to consider them when examining the impacts of celebrity-product congruence on advertising effectiveness. Accordingly, a key objective of this research is to examine the influence of congruence between celebrities’ values (as perceived by consumers) and values represented by products on advertising effectiveness, as measured by key dependent variables.

H1: High, as opposed to low, celebrity-product value congruence will result in (a) more positive attitudes toward ad, (b) more positive attitudes toward brand, (c) higher purchase intentions, and (d) higher worth-of-mouth intentions.

The earlier studies in the match-up hypothesis research stream focused on product categories and did not emphasize target consumers’ characteristics much; however, even though there is a good match between the celebrity and product, consumers’ characteristics might influence the effectiveness of the advertisement. Studies based on the self-congruity theory, which suggests that consumers prefer products with symbolic meanings that are congruent with their self-concept (Sirgy 1982), showed that congruence between values and product characteristics resulted in more favorable attitudes and higher purchase intentions (e.g., Allen, Gupta, and Monnier, 2008). Boyd and Shank (2004) studied the fit between
celebrities, consumers, and products more directly. Specifically, they examined “the effects of endorser gender, consumer gender, and the type of product advertised on consumer perceptions of endorser trustworthiness, expertise, and attractiveness” (Boyd and Shank 2004, pg. 82). By referring to the Balance Theory (Heider 1958; Feather 1964), Mowen (1980) suggested that positive cognitive relations among the cognitive elements of endorser, product, consumer, and message would result in consumers’ liking for the product. Therefore, in order to examine the impact of celebrity endorsements on advertising effectiveness truly, it is important to consider consumer characteristics at a higher level. Accordingly, the following hypotheses will be tested.

H2: Congruence, as opposed to incongruence, between celebrity values, product values, and consumer values will result in (a) more positive attitudes toward ad, (b) more positive attitudes toward brand, (c) higher purchase intentions, and (d) higher word-of-mouth intentions.

Celebrities portray different images through their professions, media presence, and lifestyles. Based on those images, consumers can attribute a certain value or multiple values to celebrities. In other words, some celebrities might be perceived as endorsing one value only while others might be associated with multiple values. For instance, celebrities like Paris Hilton or Brittany Spears might be perceived as valuing fun and enjoyment in life only. Some other celebrities, such as David Beckham or Catherine Zeta-Jones, might have more holistic images and they might have perceived to value a sense of accomplishment, fun and enjoyment in life, warm relationships with others, and self-fulfillment. In order to choose the right celebrities as an endorser of a product, it is important to understand what type of celebrities (i.e., celebrities high on one value vs. celebrities high on multiple values) are more effective. This research suggests that celebrities that are perceived to give importance to multiple values are more effective because they can be matched with several different products. Celebrities that are associated with one value, on the other hand, can only be matched with products that represent that value. Therefore, it is hypothesized that:

H3a: Celebrities that are associated with multiple values will be perceived as congruent with several products that represent different values.

H3b: Celebrities that are associated with multiple values will be equally effective (in terms of attitude toward ad, attitude toward brand, purchase intention, and word of mouth intention) when promoting products that represent different values.

**METHODOLOGY AND RESULTS**

**Overview**

The focus of this research is on the relationship between value congruence (i.e., congruence between celebrity values, product values, and consumer values) and advertising effectiveness, as measured by four key dependent variables (i.e., attitude toward ad, attitude toward brand, purchase intention, and word-of-mouth intention). To investigate these issues, three experiments accompanied with three pilot tests were conducted. Undergraduate students enrolled in business administration or marketing classes participated in all pilot studies and experiments. All participants were recruited through a subject pool and received class credits for their participation.

**Pilot Studies**

Three separate pilot studies were conducted before main studies were run. The purpose of Pilot Study 1 was to identify the values endorsed by celebrities (as perceived by consumers). Specifically, participants were instructed to rate nine values from the List of Values (Kahle 1996) scale on how important the value was for a given celebrity. Overall, 33 celebrities were rated by 546 participants. The purpose of Pilot Study 2 was, on the other hand, to identify the values associated with different
product categories. Five hundred thirty participants were asked to identify to what extent a product category was representative of nine values. Similar to Pilot Study 1, 33 product categories were rated. Celebrities and product categories used in main experiments were selected based on results from these pilot studies (Appendix A shows the ratings on each value for celebrities and products used in this research). Finally, because college students would participate in all experiments, it was important to know what values college students tend to endorse most. Accordingly, Pilot Study 3 (N=998) was conducted to measure college students’ values by using the List of Values (Kahle 1996). Specifically, participants were asked to rate nine values on nine-point scales, from “important to me” to “most important to me.” Participants then were asked to reread the items and choose one of them as the most important to them in their daily lives (Kahle 1996). The results revealed that internal values (“a sense of accomplishment”, “self-fulfillment”, and “self-respect”) and interpersonal values (specifically “fun and enjoyment in life” and “warm relationships with others”) tend to be more endorsed by college students compared to external values (“a sense of belonging”, “security”, “being well-respected”) and “excitement” (an interpersonal value).

Experiment 1

Experiment 1 was conducted to test the impact of celebrity-product value congruence and consumer values on advertising effectiveness. Because many college students tend to value “a sense of accomplishment” (based on Pilot Study 3 results), it was decided to focus on this value in Experiment 1. Among the 33 celebrities used in Pilot Study 1, Michael Jordan had the highest score on “a sense of accomplishment” (M=8.29/9.00). For the congruence condition, a product that was very high on the same value was selected: treadmill (M=5.80/9.00). For the incongruence condition, on the other hand, a product that was very low on the same value was chosen: beer (M=2.83/9.00). An independent samples t-test showed that there is a significant difference between treadmill and beer in terms of their ratings on “a sense of accomplishment” (t = 7.399, df = 139, p < .001).

Design and Independent Variables

Celebrity-product value congruence was manipulated by exposing participants to one of two experimental ads: high congruence (Michael Jordan endorsing treadmill) and low congruence (Michael Jordan endorsing beer). All other aspects of the ads (e.g., background color, the picture of Michael Jordan, name and logo of the fake brand, etc.) were the same. In order to emphasize the value being tested further, a one-sentence tagline was seen on the ad as a quote from the celebrity. Participants were assigned to different conditions randomly. Consumers’ values, on the other hand, were measured by using the List of Values (Kahle 1996). Based on the most important value selected, participants were categorized into three groups as suggested by Kahle (1996): internal values (“a sense of accomplishment,” “self-fulfillment,” and “self-respect”), external values (“a sense of belonging,” “security,” and “being well-respected”), and interpersonal values (“fun and enjoyment in life,” “excitement,” and “warm relationships with others”). Accordingly, 2 (celebrity-product value congruence: congruent vs. incongruent) X 3 (consumer values: internal vs. external vs. interpersonal) between-subjects design was used.

Dependent Variables

Two affective (i.e., attitude toward ad and attitude toward brand) and two conative (i.e., purchase intentions and word-of-mouth [WOM] intentions) were used as dependent variables.

Attitude toward ad was measured by using seven 9-point items: Likeable/ unlikeable; interesting/ boring; unattractive/ attractive; unappealing/ appealing; impressive/ unimpressive; bad/ good; and effective/ ineffective (Cronbach alpha = .939). Similarly, attitude toward the brand was measured by using seven 9-point items: something I dislike/ something I like; poor quality/ high quality; unfavorable/
favorable; negative/ positive; unattractive/ attractive; undesirable/ desirable; and unappealing/ appealing (Cronbach alpha = .889).

Behavioral intentions were measured through purchase intention and word-of-mouth intention. To measure purchase intention, the “willingness to buy” scale used by Dodds, Monroe, and Grewal (1991) was modified (Cronbach alpha = .933). To measure word-of-mouth intentions, the scale used by Price and Arnould (1999) was modified (Cronbach alpha = .961). For each of the questions, 9-point strongly disagree/strongly agree scales were used.

Manipulation Checks and Control Variables

To control for the effects of attributes associated with the celebrity (i.e., Michael Jordan), participants were asked to rate Michael Jordan on several attributes (e.g., likeability, attractiveness, familiarity, and expertise). To check for the effectiveness of the value congruence manipulation, three 9-point semantic differential items were modified from Till and Busler (2001).

Procedure

The study was conducted at a computer laboratory. After participants were provided with a brief description of what they would encounter over the course of the experimental session, they were asked to read the consent form that appeared on the computer screen in front of each participant. Then, they were directed to a website where they completed all sections of the study. The first page explained that the study was concerned with the college students’ evaluation of magazine ads. Four real ads that were selected from the Spring 2008 issues of popular women’s magazines (e.g., Vogue, InStyle, and Marie Claire) and popular men’s magazines (e.g., ESPN, and Slam) and two experimental ads that were used to manipulate the celebrity-product value congruence were presented to participants. Each ad stayed on the screen at least five seconds to make sure that participants had time to examine it. Experimental ads were placed as either the second or fourth of ads. Participants were assigned to different conditions randomly.

After participants examined all ads, they completed the measures for dependent variables (for the experimental ad only). Then, they answered questions on consumer values, manipulation checks, celebrity attributes, demographics, assessment of demand awareness, and necessary information to get their class credits (e.g., course number and instructor name). Upon completion of the Internet-survey, participants were debriefed and dismissed.

Results

Three hundred thirty three participants completed the study. Of those participants, 60% were males, 40% were females, and the average age was 21.5. An independent samples t-test was conducted to check for the manipulation effectiveness. Participants in the congruent condition reported better fit between Michael Jordan and treadmill (M = 5.37) than participants in the incongruent condition (M = 2.75; t = 10.634, df = 331, p < .001). Independent-samples t-tests also showed that there were no significant differences in the evaluation of celebrity attributes between participants who were exposed to the congruent ad (Michael Jordan endorsing treadmill) and participants who were exposed to the incongruent ad (Michael Jordan endorsing beer).

To test the impacts of celebrity-product value congruence and consumer values on dependent variables, a 2 X 3 between subjects MANOVA was performed on the following dependent variables: attitude toward ad, attitude toward brand, purchase intention, and WOM intention. With the use of the Wilks’ criterion, the combined DVs were significantly affected by the celebrity-product value congruence [F(4, 323) = 20.148, p<.001], and by the interaction between celebrity-product value congruence and consumer values [F(8, 648) = 2.798, p < .005], but not by consumer values [F(8, 648) = .566, p = .806].
Univariate tests showed that celebrity-product value congruence was a significant predictor of attitude toward ad [F(1, 326) = 49.967, p < .001], attitude toward brand [F(1, 326) = 57.649, p < .001], and WOM intention [F(1, 326) = 9.074, p < .005]. Participants who were exposed to the congruent ad had more positive attitudes toward ad (M = 5.06), more positive attitudes toward brand (M = 5.92), and higher WOM intentions (M = 4.35) than participants who were exposed to the incongruent ad (M = 3.97 for ad attitude, M = 4.67 for brand attitude, and M = 3.51 for WOM intention). Therefore, H1 was supported.

The interaction affect between celebrity-product value congruence and consumer values had significant effects on all dependent variables, namely attitude toward ad [F(2, 326) = 3.371, p < .040], attitude toward brand [F(2, 326) = 3.385, p < .035], purchase intention [F(2, 326) = 7.445, p < .001], and WOM intention [F(2, 326) = 4.543, p < .015]. Post-hoc comparisons showed that when there is congruence between the celebrity and product values, participants who endorsed external values had more positive attitudes toward ad, more positive attitudes toward brand, higher purchase intention, and higher WOM intention than participants who endorsed either internal values or interpersonal value did. No significant effect was found for the incongruent ad. These findings were contrary to expectations. Because the congruent ad emphasized an internal value, i.e., “a sense of accomplishment,” it was expected that participants with internal values would have more positive/higher dependent variable scores. Therefore, H2 was not supported. Table 1 shows the means, t-values, and p-values for the congruent ad.

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<tr>
<th>Dependent Variable</th>
<th>Means</th>
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<th>External vs. Interpersonal</th>
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</table>

**Experiment 2**

The results of Experiment 1 showed that when there is congruence between the celebrity values and product values, the ad becomes more effective in terms of attitude toward ad, attitude toward brand, and WOM intention. However, it can also be argued that there is congruence between Michael Jordan and treadmill through the expertise dimension: Michael Jordan is a sports athlete and treadmill is a sports equipment. In addition, while treadmill is a relatively expensive product not bought frequently, beer is a relatively inexpensive product that can be consumed frequently. In order to deal with these problems (i.e., expertise and huge differences in product categories), a new experiment was designed. In this experiment, a celebrity, i.e., Martha Stewart, who was relatively high on “a sense of accomplishment” and was not a sports athlete was chosen. Specifically, her rating on this value was 5.83 (out of 9) and her ratings for all other values were less than 4.80. For the congruence condition, treadmill was used as the representative of “a sense of accomplishment.” For the incongruence condition, video game console was chosen because it
was a relatively expensive product not purchased on a daily basis and its rating on “a sense of accomplishment” was relatively low (3.48). Moreover, Martha Stewart was rated on “excitement” (M = 3.35) and “fun and enjoyment in life” (M = 3.83) very low and video game console was rated on those two values very high (M = 6.03 for “excitement,” M = 6.16 for “fun and enjoyment in life”). Therefore, there was high congruence between Martha Stewart and treadmill and low congruence between Martha Stewart and video game console in terms of values. The differences between ratings of treadmill and video game console were significant, as shown on Table 2.

**Design and Independent Variables**

Similar to Experiment 1, celebrity-product value congruence was manipulated by exposing participants to one of two experimental ads: high congruence (Martha Stewart endorsing treadmill) and low congruence (Martha Stewart endorsing video game console). All other aspects of the ads (e.g., background color, the picture of Martha Stewart, taglines, etc.) were the same. Participants were assigned to different conditions randomly. Consumers’ values were measured and categorized in the same way as in Experiment 1. Accordingly, 2 (Celebrity-product value congruence: congruent vs. incongruent) X 3 (consumer values: internal vs. external vs. interpersonal) between-subjects design was used.

| Table 2 |
|-----------------|-----------------|----------|---------|
| **Comparison of Treadmill and Video Game Console** | **Treadmill** | **Video Game Console** | **t-values** | **p-values** |
| Excitement | 3.92 | 6.50 | -7.198 | 0.001 |
| Fun and Enjoyment in Life | 4.83 | 6.68 | -4.615 | 0.001 |
| A Sense of Accomplishment | 5.80 | 3.66 | 4.449 | 0.001 |

**Dependent Variables, Manipulation Checks, and Control Variables**

To make the study less demanding for participants, number of items used to measure dependent variables were decreased. Both attitude toward ad and attitude toward brand were measured by using four 9-point items: Negative/ positive; undesirable/ desirable; unappealing/ appealing; and unfavorable/ favorable (Cronbach alpha = .916 for ad attitude and .900 for brand attitude). Behavioral intentions were measured through purchase intention and word-of-mouth intention. To measure purchase intention, two items from the “willingness to buy” scale used by Dodds, Monroe, and Grewal (1991) was modified (r = .769, p < .001). To measure word-of-mouth intentions, two items modified from the scale used by Price and Arnould (1999) was used (r = .897m p < .001). For each of the questions, 9-point strongly disagree/strongly agree scales were used.

To control for the effects of attributes associated with Martha Stewart, participants were asked to rate her on several attributes (e.g., likeability, attractiveness, familiarity, and expertise). To check for the effectiveness of the value congruence manipulation, four 9-point semantic differential items were modified from Till and Busler (2001).
Procedure

The procedure were similar to the one used in Experiment 1. Participants were exposed to several ads, including real magazine ads and the experimental ads, for at least five seconds. This time, however, participants completed the measures for dependent variables after each ad. In other words, they completed the measures for both real ads and experimental ads. Then, they answered questions on consumer values, manipulation checks, celebrity attributes, demographics, assessment of demand awareness, and necessary information to get their class credits (e.g., course number and instructor name). Upon completion of the Internet survey, participants were debriefed and dismissed. Participants were assigned to different conditions randomly.

Results

Sixty five participants completed the study. Of those participants, 65% were males, 35% were females, and the average age was 20.86. An independent samples t-test showed that participants in the congruent condition reported better fit (M = 3.21) than participants in the incongruent condition (M = 1.30; t = 5.084, df = 63, p < .001). Independent-samples t-tests also showed that there were no significant differences in the evaluation of celebrity attributes between participants who were exposed to the congruent ad (Martha Stewart endorsing treadmill) and participants who were exposed to the incongruent ad (Martha Stewart endorsing video game console).

To test the impacts of celebrity-product value congruence and consumer values on dependent variables, a 2 X 3 between subjects MANOVA was performed on dependent variables. With the use of the Wilks’ criterion, the combined DVs were significantly affected only by the celebrity-product value congruence [F(4, 56) = 3.109, p<.001]. Consumer values and the interaction term between celebrity-product value congruence and consumer values did not have significant impact on the combined DVs.

Univariate tests showed that, similar to the results of Experiment 1, celebrity-product value congruence was a significant predictor of attitude toward ad [F(1, 59) = 5.119, p < .030], attitude toward brand [F(1, 59) = 6.904, p < .015], and WOM intention [F(1, 59) = 9.027, p < .005]. Participants who were exposed to the congruent ad had more positive attitudes toward ad (M = 4.10), more positive attitudes toward brand (M = 5.59), and higher WOM intentions (M = 3.78) than participants who were exposed to the incongruent ad (M = 2.76 for ad attitude, M = 4.03 for brand attitude, and M = 1.93 for WOM intention). These results provided evidence for H1 but failed to confirm H2.

Experiment 3

The purpose of Experiment 3 is to test the hypothesis that celebrities rated high on multiple values will be perceived congruent with products representing different values. Accordingly, there will be no significant differences in terms of dependent variables. The results of Pilot Study 1 showed that Julia Roberts was perceived as endorsing multiple values. Indeed, except two values (i.e., “excitement” and “security”), the ratings were all higher than 6.15 (out of 9). To test for the hypotheses, three products that were representative of three different values were selected. Specifically, watch was used to represent “a sense of accomplishment” (5.68/9.00); dinnerware set was used to represent “warm relationships with others” (5.79/9.00); and luggage was used to represent “fun and enjoyment in life” (4.63/9.00). It should be noted, however, that these three products were also rated high on some other values (see Appendix A).

Design and Independent Variables

Similar to Experiment 2, celebrity-product value congruence was manipulated by exposing participants to one of three experimental ads. However, this time, it was assumed that, because Julia Roberts was high on multiple values, the congruence between celebrity and all three products would perceived to be high. Therefore, three ads with high congruence were created: Julia Roberts promoting a watch, Julia Roberts promoting a dinnerware set, and Julia Roberts promoting a luggage. Because
selected products were also rated high on some other values, taglines were used to emphasize the main values represented by products. All other aspects of the ads (e.g., background color, the picture of Julia Roberts, the name and logo of the brand, etc.) were the same. Participants were assigned to different conditions randomly. Consumers’ values were measured and categorized in the same way as in Experiment 1 and 2. Accordingly, 3 (product values: a sense of accomplishment vs. warm relationships with others vs. fun and enjoyment in life) X 3 (consumer values: internal vs. external vs. interpersonal) between-subjects design was used.

**Dependent Variables, Manipulation Checks, and Control Variables**

The same measures used in Experiment 2 were used in Experiment 3. The Cronbach alpha was .966 for attitude toward ad and .956 for attitude toward brand. Pearson correlation was .876 (p < .001) for purchase intention items and .841 (p < .001) for WOM intention items.

**Procedure**

The procedure were similar to the one used in Experiment 2. Participants were exposed to several ads, including real magazine ads and the experimental ads, for at least five seconds and they completed the measures for dependent variables after each ad. Then, they answered questions on consumer values, manipulation checks, celebrity attributes, demographics, assessment of demand awareness, and necessary information to get their class credits (e.g., course number and instructor name). Upon completion of the Internet-survey, participants were debriefed and dismissed. Participants were assigned to different conditions randomly.

**Results**

Fifty four participants completed the study. Of those participants, 46% were males, 54% were females, and the average age was 20.94.

A series of independent samples t-tests showed that, as expected, the congruence between Julia Roberts and three products was not significantly different from each other, confirming H3a. Table 3 shows the means, t-values, and p-values. Independent-samples t-tests also showed that there were no significant differences in the evaluation of celebrity attributes between participants who were exposed to different experimental ads.

### Table 3

<table>
<thead>
<tr>
<th>Dependent Variable</th>
<th>Means</th>
<th>Watch vs. Dinnerware Set</th>
<th>Watch vs. Luggage</th>
<th>Luggage vs. Dinnerware Set</th>
</tr>
</thead>
<tbody>
<tr>
<td>Congruence between Celebrity and Product</td>
<td>Watch: 4.00</td>
<td>Dinnerware Set: 3.07</td>
<td>Luggage: 3.80</td>
<td>t-values (p-values): 1.560 (p = .128)</td>
</tr>
</tbody>
</table>

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To test the impacts of celebrity-product value congruence and consumer values on dependent variables, a 3 X 3 between subjects MANOVA was performed on dependent variables. As expected, because the congruence level was the same across three different ads, the combined DVs were not significantly affected by the celebrity-product value congruence \( F(8, 88) = 1.260, p = .275 \), supporting H3b. Consumer values and the interaction term between celebrity-product value congruence and consumer values did not have significant impact on the combined DVs either. H2 was not confirmed.

**DISCUSSION**

The match-up hypothesis suggests that there should a good match-up between the celebrity and the product promoted by the celebrity. Previous research has provided evidence for the match-up dimensions: attractiveness and expertise. This study attempts to add further insights to the match-up hypothesis of celebrity endorsements by introducing a higher-level construct: social values. Indeed, the results showed that high congruence between celebrity values and product values resulted in more effective ads (i.e., higher attitudes toward ad, higher attitudes toward brand, and higher WOM intentions). In addition, the results provided insights to show that celebrities that are associated with multiple values might be used to promote different kinds of products because those celebrities are perceived to be congruent with different products.

It is also argued in this study that consumer values would matter and the congruence between celebrity values, product values, and consumer values would lead to more effective ads. However, this hypothesis was not confirmed. In the first experiment, significant results were found but these findings were contrary to expectations. Because the congruent ad emphasized an internal value, i.e., “a sense of accomplishment,” it was expected that participants with internal values would have more positive/higher dependent variable scores. The results, in contrast, showed that participants with external values had higher scores on dependent variables. These findings suggest that consumers do not like extreme congruence. In other words, it is possible for consumers to prefer a kind of “surprise” effect (Lee and Thorson 2008). Alternatively, because there was incongruence, participants with external values might have elaborated more on the ad, which might lead to positive/higher dependent variable scores. In Experiment 2 and 3, on the other hand, no significant results related to consumer values were found. One reason for this finding might be the small sample size in those two experiments. Additional research is necessary to understand the underlying reasoning behind the results.

Future research can also be conducted to examine the impact of manipulating celebrity values on congruence perceptions and subsequent dependent variables. For instance, the results of Pilot Study 1 showed that some celebrities, such as Jennifer Anniston or Meryl Streep, are not associated with any value significantly (ratings on all values were less than 5.00 for both Jennifer Anniston and Meryl Streep). The perceptions of values endorsed by those celebrities might be manipulated to have a good match with the product promoted, which will lead to higher scores on key variables.

Another opportunity that might be worth to pursue is to extend the application of celebrity-product value congruence to social marketing issues. Almost all celebrity endorsement research focuses on for-profit companies and physical products; however, celebrities are also used in social marketing campaigns. Social marketing issues can be considered as either internally related to consumers (as in the case of quitting smoke, using condoms, or self-examination for breast cancer) or externally related to consumers (as in the case of donating to charities, recycling, or helping poor people). Accordingly, it can be expected that celebrities who represent internal values can be more effective in promoting internally related issues than promoting externally related issues. Similarly, celebrities who represent external values can be more effective in promoting externally related issues than internally related issues.
### APPENDIX A

Table A.1

<table>
<thead>
<tr>
<th></th>
<th>N</th>
<th>Sense of belonging</th>
<th>Excitement</th>
<th>Warm relationships</th>
<th>Self-fulfillment</th>
<th>Being well-respected</th>
<th>Fun and enjoyment</th>
<th>Security</th>
<th>Self-respect</th>
<th>A sense of accomplishment</th>
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</thead>
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<tr>
<td><strong>Celebrities</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
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<td></td>
<td></td>
</tr>
<tr>
<td>Michael Jordan</td>
<td>52</td>
<td>6.25</td>
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<td>7.54</td>
<td>8.10</td>
<td>7.37</td>
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<td>7.23</td>
<td>8.29</td>
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<td>4.40</td>
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<td>4.78</td>
<td>4.70</td>
<td>4.05</td>
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<td>5.83</td>
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<td>Julia Roberts</td>
<td>51</td>
<td>6.18</td>
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<td>6.16</td>
<td>6.41</td>
<td>7.06</td>
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<td>Treadmill</td>
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<td>2.59</td>
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<td>2.83</td>
</tr>
<tr>
<td>Video Game Console</td>
<td>56</td>
<td>3.32</td>
<td>6.50</td>
<td>3.30</td>
<td>3.41</td>
<td>2.57</td>
<td>6.68</td>
<td>1.73</td>
<td>2.45</td>
<td>3.66</td>
</tr>
<tr>
<td>Wrist Watch</td>
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<td>5.25</td>
<td>3.96</td>
<td>3.82</td>
<td>4.61</td>
<td>6.14</td>
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<td>4.57</td>
<td>5.11</td>
<td>5.68</td>
</tr>
<tr>
<td>Luggage</td>
<td>46</td>
<td>2.72</td>
<td>3.96</td>
<td>2.30</td>
<td>3.02</td>
<td>3.74</td>
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<td>3.37</td>
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<td>19</td>
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<td>5.05</td>
<td>4.00</td>
<td>3.63</td>
<td>4.21</td>
<td>4.05</td>
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</tbody>
</table>
REFERENCES


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DO WE POSSESS OUR BODY?: THE EXPLORATION OF THE BODY AS SUBJECT THROUGH THE EXPERIENCES OF PREGNANCY AND CHILDBIRTH

Hyun Jeong Min, University of Utah

ABSTRACT

This study explores the dynamics of the body and the self through the pregnancy related experiences of Korean women in the United States. In-depth interviews with six Korean women who experienced their pregnancy in the United States revealed that the changes in their body during and after pregnancy led to changes in the way they construct their self identity in their everyday life. Internally they disavowed their body from their conceptualization of the self and put a stop to their fashion consumption. In terms of social relationships, they thought of themselves and their baby as a pair and engaged in the process of self construction through the sacrifice of their own wants and desires. The cultural context that these women were situated in also influenced management of their body. In this study, these processes are explained, the theoretical implications for the theory of the self identity are discussed, and managerial implications for fashion marketing are given.

INTRODUCTION

The human body has become one of the most popular and contested topics in the social sciences reflecting a trend in contemporary consumer culture (Howson and Inglis 2001; Shilling 2007). These studies have informed us that contemporary consumers engage in various consumption behaviors to meet their conceptualization of the self (Askegaard, Gertsen, and Langer 2002; Schouten 1991) and such actions are not decided solely by individual motivation and psychology but that the cultural discourse in which the individuals are situated plays an important role in producing such social practices (Thompson and Haytko 1997; Thompson and Hirschman 1995).

As an empirical setting for studying bodily identity construction, many researchers have focused on various body modification practices such as dieting, tattoos, and plastic surgery. Despite the significant contribution of these studies, social scientists’ concentration on body modification practices resulted in a gap in self identity theory in a few aspects. First of all, the consumption practices of body modification starts from the consumers’ mind. That is, consumers have to make a decision to modify their body whether it is tattooing or plastic surgery before they experience it. As a result, this tendency leaves out other body changes that start to happen usually without the mind’s knowledge such as aging, puberty, and menopause. Sudden body changes accompanying illnesses and accidents also have not received much attention even though these changes usually lead to changes in consumption behaviors (Charmaz 1995; Corbin 2003; Murphy 1987).

Second, the changes made by body modification practices tend to be perceived as positive to consumers. As a result of aesthetic plastic surgery, for instance, consumers usually get an enhanced self image and more confidence. For this reason consumers do spend money and endure the pain of intervention procedures to obtain a more beautiful body. On the contrary, natural body changes are usually very negative in nature. Diminishing eyesight due to aging or losing mobility by car accidents are very disturbing for almost everyone, and these changes tend to damage the integrity of consumers’ personal and social identity (Murphy 1987). Therefore, it is natural to assume that the adaptation process to these negative body changes will be very different from the adaptation to changes through body modification, and understanding the impact of various negative changes on consumers’ self identity through the framework of body modification can be limited.
Third, because the decision of engaging in body modification starts from the consumers’ mind, people are conscious of their body changes at almost the same time they experience it. That is, the time lag between the ontological changes and epistemological changes or becoming aware of the changes rarely exists. For this reason it is very easy to assume that consumers will perceive their body changes at the same time they experience them. However, we can understand that this is usually not the case when we refer to naturally occurring body changes in our everyday experiences. Think about the experience in which you suddenly realize that you have a lot of wrinkles around your eyes and or that you have gained weight. Although these changes might have been happening little by little, most people don’t realize them until a moment of truth finally comes. In other words, consumers’ epistemological changes do not necessarily happen at the same time with their ontological changes, and acknowledging this discrepancy can lead to significant insights about individuals’ consumption practices.

Another important point is that when undergoing body modification, we tend to see our body as an object that can be controlled through various interventions and to pay little attention to our body as a subject (Merleau-Ponty 1962) in the process. As Merleau-Ponty says, when we touch our right hand with our left hand, we are touching as a subject and at the same time are being touched as an object. To shed light on the body as subject aspect, therefore, we need to turn toward other bodily changes rather than those from body modification.

To overcome the limitations mentioned above, I turn toward women’s experience of pregnancy. The corporeal experiences of pregnancy, childbirth, and the postnatal body offer a fascinating opportunity to explore the change of dynamics in the relationship of the self and body (Giddens 1991; Shilling 1993) for a few reasons. First of all, pregnancy related experiences are naturally occurring events, different from self imposed body modification practices. Moreover, body changes during and after pregnancy tend to be negative as seen in weight increase and ruined body shape, and this provides researchers with an antipode to positive changes accompanying body modification consumption practices.

More importantly, dramatic changes that women experience during pregnancy represent epiphanic experiences (Denzin 1992) in women’s bodily lives, which rupture routines and lives, and provoke a radical redefinition of the self (Strauss 1959), providing a good entry point to study the process of body initiated self change. In addition, pregnant women tend to be more reflexive about their body for a few reasons. They are usually very careful to keep their body safe and healthy for their baby and to look at their bodies to remind them about the birth and consequent changes in their lives (Bailey 1999). After delivery, a kind of tension exists between their new self as a mother and an individual who is struggling to get a particular body and self back. All of these make the experience of pregnancy and childbirth a fertile empirical setting for consumer researchers who study the relationship between the body and the self.

Finally, pregnancy usually leads to changes in consumption behaviors. Pregnant women engage in, and withdraw from, a range of activities in relation to their pregnancies. (Bailey 1999). Such consumption changes accompanying pregnancy make this lived experience more interesting in terms of consumer studies.

By examining the corporeal experiences of pregnancy, childbirth, and postnatal body, in this paper, we expect to illuminate how consumers construct their identity when they experience naturally occurring, potentially negative body changes as well as to reveal consumption changes. Moreover, various body changes occurring during and after pregnancy regardless of individual’s intention will provide an effective empirical setting to investigate the body as subject (Merleau-Ponty 1962)
LITERATURE REVIEW

Body/Mind Dualism

In Western culture, a so-called Cartesian dualism has dominated the conceptualization of the relationship between the body and the mind. The central claim of this body/mind dualism is that the body is a passive container that acts as a shell to the active mind (Shilling 2008). This idea places the mind in a hierarchically superior position over and above nature, including the body (Grosz 2005). Until now this ideology of dualism has constructed a variety of self care practices for consumers (Thompson and Hirschman 1995). In a strict form of dualism there are two distinct, mutually exclusive and exhaustive substances, which are the mind and the body. Each mind and body inhabits its own self-contained sphere and the two have, therefore, incompatible characteristics (Grosz 2005). With the scholastic accomplishments in postmodernism and post-structuralism, however, researchers have shown that the body and the mind are neither mutually exclusive nor exhaustive. Contemporary research emphasizes the interplay between the two, trying to overcome the dualism of the body and the mind despite some differences of focus in each study.

Reflexivity between the Body and the Self

Recent research on consumer self has paid much attention to consumers’ reflexive self construction process. These researchers saw that human body and mind interact with each other in a dialectic way raising doubts about the notion of the human body as a machine controlled by active mind.

In his seminal research on extended self, Belk (Belk 1988; Belk and Austin 1986) presented that individuals attach great importance to their body parts in terms of their self identity. In the study of organ donation willingness, Belk and Austin (1986) showed how much of self-ness is endowed to various body parts by their owners and that body parts are central to conceptions of self. Therefore losing or damaging one’s body parts will have a detrimental effect on one’s identity (Belk 1988). We can find a good example of the damaged identity by losing body’s function from the autoethonography of Robert Murphy, a renowned anthropologist. In his ethnography Murphy (1987) illustrates painstakingly how his self concept, social relationship, and perception about reality are affected as his illness progresses. Murphy’s (1987) detailed description of his experience of quadriplegia clearly supports that body parts and the body itself are among the foundations upon which people build their sense of who they are.

The body as a foundation for building one’s identity leads to the practices of adornment and modification of the human body. A variety of body modifications and adornments such as tattooing, scarring, piercing, using make-up, dressing, and hairstyling have been ways of exhibiting identity through differentiation from or assimilation with certain members of society. (Velliquette, Murray, and Evers 2006) In other words, people use their body as one of the resources for signaling their inner self or making their identity statement.

In studying self expression through the body, one group of researchers has focused on the role of the social. These scholars showed how oppressive gender and capitalist ideologies influence and shape the body management regimes of individual consumers. Especially feminists and critical theorists usually take this stance a frequently drawing on Michel Foucault’s theory about the body. According to Foucault, the body is a site where regimes of discourse and power inscribe themselves. He claims that the body is a site of struggles among culturally contested meanings (Butler 1989). Drawing on Foucault, Bordo (1993) shows that the ideal of a slender and tight body for women has been constructed by social discourses that see the female body as a manageable text of femininity. For instance, a fat body on a woman can be read either as a lack of self control or as resistance to the monolithic beauty ideal of contemporary society. These different meanings struggle to acquire hegemony in a given society and a certain meaning will get the dominant position in the field of discourse. The reality that a lack of self control is the dominant interpretation of a fat body on a woman indicates that this meaning is hegemonic in contemporary society.
As a result, individuals will engage in bodily practices produced by this dominant meaning such as dieting and plastic surgery. Similar to Bordo, Thompson and Hirschman (1995) demonstrated that individuals’ satisfaction about their appearance and the sense of an ideal body do not remain in the territory of individual perception but are socially constructed through the interaction between individual consumers and a variety of cultural ideologies. Their point about the socialized body is quite apparent in the autoethnography of Sayre (1999) as well. She describes how social norms and popular culture influenced her to succumb to the beauty myth of contemporary American society and her decision to have a facelift operation.

Another group of research has focused more on the empowering aspects of constructing self identity through various body modification consumption practices. Although these studies also acknowledged the social construction aspect of body regimes, they have concentrated more on the reflexive process of self construction. In his study of consumers who experienced plastic surgery, Schouten (1991) demonstrated that individuals consider their plastic surgery as a self-imposed rite of passage to take control of their body. Their changed body becomes the foundation for their improved self identity and this eventually leads to the changes in their consumption behaviors. In the same vein, Askegaard, Gertesen, and Langer (2002) also studied consumers who experienced plastic surgery drawing on Giddens’s work on self identity in late modernity. They saw plastic surgery as a part of a reflexive self construction process and focused on the issues of self determination, self-esteem and the relationship of body and identity.

Besides plastic surgery, tattooing was another phenomenon to attract consumer researchers (Kjeldgaard and Bengtsson 2005; Velliquette et al. 2006). Paying attention to the increasing popularity of tattooing as a conspicuous consumption practice among the general public, Kjeldgaard and Bengtsson (2005) explored consumers’ motivation to tattoo as a fashion statement. Velliquette et al. (2006) showed that individuals use having tattoos as part of the struggle for their identity. Incorporating various life transitions and personal events their participants tried to weave a coherent identity narrative using tattoos as a prop.

**Limitation of Reflexivity**

In contrast to what simple Cartesian dualism says, both groups of studies suggest that the human mind and body affect each other in building one’s identity and this process consists of an ongoing reflexive process although one group focuses on the empowering effect of individual body project, and the other emphasizes the social construction aspect. By introducing the notion of reflexivity into their research, these two groups of studies on the body could overcome the simple body/mind dualism, but the limitation of the notion of reflexivity prevented them from seeing the whole picture in the relationship between the body and the self.

To better understand reflexive self construction, we need to refer to Giddens’ modernity theory first. Giddens claims that under the conditions of late modernity, the human body takes the center position in the identity construction process. In his theory, the human body is considered to be a malleable thing to be modified and improved through various consumption practices such as regular exercise, dieting, stylish dresses, and plastic surgery. Therefore individuals tend to invest more in their body to express their identity outwardly. (Baudrillard 1998; Giddens 1991; Kjeldgaard and Bengtsson 2005; Shilling 2008) The body is less and less of an extrinsic given that one must live with regardless of one’s liking and has become a site of reflexive construction (Askegaard et al. 2002; Giddens 1991). According to Giddens (1991, 102), individuals are now able to restructure their malleable flesh and have become responsible for “the design of their own bodies” or as one might say, the creation of the body.

The notion of reflexive self construction has contributed to overcoming the simple body/mind dualism by emphasizing the interactive relationship between the two. Despite the contribution, however, this does not change the fundamental mind/body dualism underpinning Giddens’ inspired works.
Although Giddens’ analysis of modernity suggests that the body has taken center stage in the shaping of individual identity, people remain essentially minds in his writings on modernity. For Giddens (1991), reflexivity is “a form of mental engagement with the world facilitated by a cultural context in which society has substantially colonized nature and the body” (Shilling and Mellor 1996, 2). For instance, in order for individuals to have a tattoo, be on a diet, or undergo liposuction, for instance, they have to make a decision before engaging in such bodily consumption in their mind. In other words, the starting point of various body modification practices is always the human mind whether individuals are under the influence of socio-cultural ideologies or their action is a result of active reflection on their self. In addition, an assumed malleability of the body means that the coherence of our self-identities is now a concern for the mind all the more. The body became more important in late modernity because it has to be molded to fit an individual’s narrative of self (Shilling and Mellor 1996). For this reason, Giddens’s analysis does not change the fundamental notion of mind over body in Cartesian dualism. The root of the proposition of mind over body lives out in these practices of body modification and the human body is only seen as an object. As a result, this leaves out another important aspect of the human body, which is the body as subject (Merleau-Ponty 1962).

**The Body as Subject**

Symbolic interactionism has well established that the human capacity for reflexivity allows one to turn back upon and objectify oneself. Mead (Mead and Morris 1934) explained this point by using the notions of the ‘I’ and ‘me’ to distinguish the self as subject and object. This idea of the self as subject at the same time being an object can be extended to explain our body. We both are our body, and at the same time we have a body (Crossley 2005). Drawing on this accomplishment, a number of empirical studies have focused on the aspect of the body as an object (Askegaard et al. 2002; Baudrillard 2005; Bordo 1993; Domzal and Kernan 1993; Featherstone 1982; Jagger 2000; Schouten 1991; Schroeder and Zwick 2004; Thompson and Hirschman 1995). It is true that people make objects of their bodies by engaging in various consumption behaviors such as protecting and adorning them with clothes and nurturing them with food (Corbin 2003). We are not denying this apparent fact here but pointing out that consumer researchers as well as other social scientists have neglected the body as subject in their empirical research while concentrating on the objectification of our body.

The objectified body is the part of the self considered to be the source of impediment that must be governed. The self endeavors to overcome the limitations of its objectified body by extending given capacities and cultivating new ones. In the one-sided concern for the body as object, consideration of the body as subject, which is clearly acknowledged in the theoretical works of Mead and Merleau-Ponty, is missing.

In our everyday life, the body as subject is most likely to emerge in illness and aging (Gadow 1980). Considering the increasing importance of aging and illness in the contemporary consumers’ life, the empirical study of the body as subject seems to be an urgent matter. By attending to the subject body, consumer researchers can grasp the dialectical relationship more fully, complementing empirical works on the object body. (Gadow 1980)

**The Phenomenology of Merleau-Ponty**

The phenomenology of Merleau-Ponty shed light on ways to overcome the underpinning notion of mind over body in the study of the object body. By emphasizing the body as subject Merleau-Ponty (1962) attempted to overcome the Cartesian dualism that sees the human body only as an object. In this respect, his theory is very valuable for a researcher who wants to complement the limitations of studies on the object body. Still Merleau-Ponty accepts that the body has an object side or a sensible side which can be seen and touched. However, he adds that the human body has another side, a subject side which sees and touches and which thereby experiences its world meaningfully (Crossley 1995; Morris 2008). Despite its subject side, the body is not characterized by the attributes of the classical subject with autonomy.
Rather it indicates that the body is more than just an object (Crossley 1995; Morris 2008). In other words, human beings are neither purely ‘minds’ or subjects’ nor mere ‘bodies.’ Therefore the total nature of the human being is best grasped if one refers to them as body-subjects (Merleau-Ponty 1962). Merleau-Ponty explains the body as both subject and object with the phenomenon of double sensations. He says,

My body, it was said, is recognized by its power to give me ‘double sensations’: when I touch my right hand with my left, my right hand, as an object has the strange property of being able to feel too. We have just seen that the two hands are never simultaneously in the relationship of touched and touching to each other. When I press my two hands together, it is not a matter of two sensations felt together as one perceives two objects placed side by side, but of an ambiguous set-up in which both hands can alternate the roles of ‘touching’ and being ‘touched.’ What was meant by talking about ‘double sensations’ is that, in passing from one role to the other, I can identify the hand touched as the same one which will in a moment be touching (Merleau-Ponty 1962,106).

Acknowledging the human body as both subject and object has huge implications for consumer researchers because this realization enables researchers to see the gap between ontological and epistemological changes in consumer self. Phrases such as “moment of truth” and “wake-up call” remind us of the lagged realization of certain changes in our body or ontological changes. It is very common that individuals may suddenly realize that they have gained weight when attempting to put on old jeans or have gained a lot of wrinkles around their eyes when looking in the mirror. In more serious cases individuals suddenly come to know that they have certain diseases such as cancer (Pavia and Mason 2004). Even when people do not experience some noticeable changes, they come to know the peculiar characteristics of their body over the years such as how their body reacts to stress, how much they can work before becoming tired and what happens when they eat too much. In many identity related body changes occurring during adolescence, pregnancy, menopause, and aging, there is still that sense of “knowing one’s own body” (Corbin 2003).

The body and the self are usually viewed as a unit until the body can no longer perform properly at one’s will. When the body becomes severely disabled, a body/mind split, or a differentiation of self and body, happens quite often. When this happens, people start saying that they are more than their body, reminding themselves and other people that the person within the body is still there even if it can’t function (Corbin 2003; Murphy 1987). This split between a body and a mind provide consumer researchers with windows to observe the difference between ontological and epistemological changes in a person’s self, which is very hard to examine in the consumption of various body modifications.

**METHODOLOGY**

**Data Collection and Analysis**

We conducted an interpretive study using phenomenological in-depth interviews to attain a first-person description of body changes and feelings, thinking and behaviors related to those body changes (Thompson, Locander, and Pollio 1989). All the interviews were conducted by the first author in Korean. A loosely structured interview guide (Lofland et al. 2006) was developed to remind the researcher of any important topics to be covered in the interviews. The interview was open ended and flexible based on the flow and the pace of participant narratives. All six participants were interviewed. The interviews lasted 1 to 2 hours and were conducted in the participants’ homes except for one interview done by using an instant messenger software program.

All of the participants were Korean women who experienced pregnancy and childbirth while living in the United States. By studying Korean women in the United States it was expected that researchers could get the insight about the effect of spatial movement of the body from the native country to a foreign one as well as the body and the self interplay during and after pregnancy. The ages of the participants
ranged from 26 to 37. Originally recruitment ads were put around campus in order to recruit participants, but this was not fruitful. For this reason, participants were recruited by networking through friends and by referral. For reasons of confidentiality, all participants are referred to by pseudonyms throughout the article.

Interviews with participants began with grand tour questions (McCracken 1988; Spradley 1979) pertaining to their biographies of notable body changes during and after pregnancy. Overall interview questions covered the body changes during or after pregnancy; the meanings embedded on those body changes in terms of their identity as a woman, wife, and mother; and the changes in their everyday consumption such as food, fashion, and entertainment during and after pregnancy. All interviews were fully transcribed and resulted in 155 typed single-spaced pages.

For the convenience of data analysis, Atlas.ti was used. Analysis was an iterative process of coding, categorizing and abstracting the data (Schouten 1991; Spiggle 1994). As guidance for the entire analysis process, a hermeneutical framework suggested by Thompson (1997) was used. The first phase of analysis started with line-by-line coding, naming or categorizing each line or segment of the written data (Charmaz 2006; Glaser 1978; Spiggle 1994). In the second phase of coding, we identified the most significant or frequent earlier codes to sort, synthesize, integrate, and organize the data (Charmaz, 2006). In the entire coding process, we tried to be sensitive to repetitions of incidents or words, irregularities, unusual occurrences and the ways in which people speak (Bryman and Burgess 1994). The provisional understandings of consumers' experiences were formed, challenged, and revised through the iteration between individual transcripts and the emerging themes of the entire set of data (Thompson and Arsel 2004). For the analysis, Korean transcripts were used, and excerpts provided in this article were translated by the first author.

**Brief Description of Participants**

*Yoon-Jeong*

At the time of the interview, she was 32 years old. She had been living in the United States for five years. Her son was two years old. She worked as a marketer in an IT company when she was in Korea. She was overweight before the pregnancy. She got prenatal diabetes during pregnancy and had to go on a strict diet to handle the situation. Because of this, her weight only increased by one pound during the pregnancy. In the early stage of pregnancy she experienced severe nausea and vomiting and had to stay in bed for almost a month. She also experienced hair loss. After stopping breastfeeding, her weight increased drastically experiencing great stress about that.

*Ji-Young*

She was 33 years old and had been living in the United States for three years. She gave birth to her son five months before the interview. She experienced weight increase, hair loss and body shape change during and after pregnancy. She underwent very serious nausea and vomiting in her early stage of pregnancy. Due to this she barely ate anything for two months. She even vomited after drinking water, so she had to rely on IV fluid. As a result, she experienced a weight decrease of ten pounds by her tenth week. She couldn't eat even her favorite food during pregnancy. Although many people said that she did not look like she had gained weight because of the weight loss during the early stage of her pregnancy, she perceived clearly she had gained weight and her shape had been changed. Due to the shortage of breast milk she had to eat more than her usual diet and gained much weight.

*Jin-Sook*

She was 35 years old and had the experience of giving birth to her daughter when she was in Korea. Her son was born almost two years before the interview. She was in her fourth year living in the United States. While she was pregnant with her son, she gained 60 pounds. Over one year after childbirth she lost
almost what she gained during pregnancy but she was still six pounds overweight compared to before her second pregnancy. Despite the weight loss, she could not restore the body shape she had before. She felt that her skin got old drastically and gained more wrinkles after her second childbirth.

**Eun-Hee**

She was 36 years old. She had been living in the United States for five years. She had studied in a graduate program before getting married with her husband, who was an old friend. She gave birth to her son about two years before the interview. During her pregnancy she gained twice as much weight as is considered proper. She ate a lot even after her delivery due to her postnatal depression. She did not remember how much weight increase she had. She said she wore a size eight before pregnancy but now wore size 14. She had barely lost her pregnancy weight until then.

**Se-Ran**

She had been living in the United States for three years and was 32 years old at the time of the interview. Her daughter was almost one year old. Her first pregnancy ended with a miscarriage but she gained some weight. To strengthen her weakened body after her miscarriage, she ate well and gained more weight. Before losing the increased weight, she got pregnant again and gained more weight. After childbirth she tried various diet methods and lost around 15 pounds. Still she weighed 13 pounds more than before her first pregnancy.

**Hee-Won**

She was 26 years old and had been living in the United States for over three years when she had the interview. Her daughter was one year old. Unlike the other participants, most of whose family members were living in Korea, her whole family had immigrated to California. She lived there for one year and got married with another Korean immigrant. Then she moved with her husband to the state where this study was being conducted. During her pregnancy, she visited California very often to stay in her parents’ home and gave birth to her daughter in a Korean hospital in California. Her weight gain was less than 30 pounds, which is considered as to be the proper weight gain during pregnancy. Because of breastfeeding her weight became two pounds less than she had before pregnancy. Her most memorable pregnancy related body change was stretch marks.

**RESEARCH FINDINGS**

**Uncontrollable Body and Feeling disturbed**

During and after pregnancy, the participants experienced various body changes including weight gain, hair loss, stretch marks, ruined body shape and prenatal diabetes. Most of the participants had kept the stability between the body and self before their pregnancy. Despite experiencing small weight fluctuations, they had kept their body and self in unity over a relatively long time, and did not have much complaint about their body. However the body changes resulting from pregnancy were relatively drastic compared to their past experiences and these body changes seemed to undermine the stability and unity between their body and the self. Moreover, these changes made participants realize that they are not in full control of their body.

Although body changes and symptoms during pregnancy were not unexpected for these women, the degree of changes and accompanying pain were unexpected and there was a great deal of difficulty in actually undergoing these changes. Half of the participants experienced severe nausea and vomiting and could not eat any food for some time. Se-Ran mentioned that all foods smelled like ditch water because her olfactory sense became too sensitive. Ji-Young suffered from severe morning sickness and she could not eat almost anything for two months. As the sickness became severe she had to rely on intravenous injections of nutrients. Yoon-Jeong underwent prenatal diabetes and all participants experienced hair loss. The common thing about these body changes was that these changes were not controllable by the owner.
of the body. This uncontrollability is clearly shown in the following excerpts from the transcripts describing their morning sickness, cravings and highly stimulated appetites.

I had severe morning sickness in my early pregnancy. It was much more severe when I first got pregnant and miscarried my baby. There was nothing for me to want to eat. Actually I couldn’t eat. Then almost every food smelled like ditch water. I could not eat anything but cucumbers, carrots and some bread. So I did not have any appetite for any food and this symptom lasted very long. As morning sickness disappeared, I had a miscarriage. (Se-Ran)

When I experienced morning sickness, I could not eat anything but Korean food and some meat. Once I cried out watching a Korean cookbook and kept saying “wanna eat this, wanna eat this.” I stayed lying in bed for almost a month. (Yoon-Jeong)

My breast milk production was so low at first. It has been just two weeks since milk production became okay. … Although I ate a lot of food intentionally to make more breast milk, my appetite was really stimulated. I was hungry for 24 hours every day even though I didn’t feel that I could give that much breast milk to my baby. My appetite was too strong for me to control and I felt really exhausted. (Ji-Young)

Various body changes accompanying pregnancy and childbirth were way beyond their control. On the contrary their body changes seemed to control their everyday lives as seen in lying in bed all day long and relying on intravenous injections of nutrition. Although physicians have claimed that nausea and vomiting during pregnancy are caused or aggravated by psychological factors, research evidence has been inconclusive and contradictory (Leifer 1980). Reflecting this inconclusive support for psychological influence on nausea and vomiting, most of the participants said they did not know about psychological factors when the researcher mentioned it. When the interviewer mentioned about psychological factors in her severe morning sickness, Se-Ran actually showed a slightly unpleasant feeling about the question. This is very different phenomenon from the findings in the research of body modification, in which consumers take control over their body changes. The pregnant body was not a malleable resource for these women to mold to fit their identity ideal but an uncontrollable subject.

Weight gain and ruined body shapes were the body changes that participants felt most stressful and worried about. Morning sickness subsided as time went by and prenatal diabetes disappeared with childbirth, but pregnancy weight did not go away. Hair loss did not recover fully even two years after childbirth. Due to the increase of eating for breastfeeding some gained weight more than when they were pregnant and some gained weight after stopping breastfeeding.

Disturbances from these negative body changes were very strong among participants. One of participants, Ji-Young, said that there was nothing positive about all the body changes she had to experience because of pregnancy and childbirth. She had never thought that she could have that heavy of a body compared to her past. She weighed the most in her entire life when she had an interview with us. She expressed strong discomfort for the situation, and her most feared identity was azumma, which refers to a married woman in Korean but contains plenty of negative cultural connotations such as being fat, not sophisticated or fashionable, unyielding, and shameless.

When I saw my stomach, what can I say; I didn’t feel like that it was me. It was very awkward because I felt that it was not like the me that I have known from the past. I was scared about what might be happen to me in the future. I thought that I might become an azumma like my mom after I gave birth to a baby. (Ji-Young)
Participants expected that negative changes which occurred during pregnancy would disappear with childbirth and they could go back to the state before the pregnancy. Things like prenatal diabetes disappeared but many changes lingered on their body like stretch marks which were still there after losing pregnancy fat. Most of the participants were struggling to lose the pregnancy weight but the weight was very stubborn. Even when they regained their pre-pregnancy weight, changed body shape stayed with them. This stubbornness of their body made participants stressful and irritated.

**Lagged Epistemological Changes behind Ontological Changes**

The disturbed feelings of participants were aggravated when they realized their changed body at a certain moment such as when looking in a mirror or taking pictures. Ji-Young mentioned that she was really surprised when she saw her body swollen “like a balloon” in the hospital right after childbirth. Se-Ran also said that she did not realize how she had changed until she saw how she looked in her husband’s t-shirt in a restroom of the church that she goes to. Most of participants also said that they became more reluctant to have pictures taken of themselves because they wanted to avoid the moment of confronting the reality of their body through photos.

I rarely took a picture of myself because I didn’t like it. Originally I didn’t enjoy having pictures taken. I can live without being disturbed if no pictures were taken of me. But as I look at my photos, I begin to become concerned about my appearance and become sad. That’s why I don’t like being photographed. (Se-Ran)

Someday I looked into the mirror and thought, “Ah... you became so uncouth and fat. Now you’ve really become an azumma. You really don’t have any style.” I thought things like that. And I got vexed so much. I don’t want to look into the mirror. Whenever I look into it, I get irritated. (Eun-Hee)

The experiences of suddenly realizing their changed body or confronting with the moment of truth illustrate that ontological changes of body and the awareness of these changes are discrete matters. That is, while we do not perceive these changes, our body has been changing bit by bit. This finding also informs us that consumption changes come with the realization of body changes or epistemological changes rather than with ontological changes themselves. Se-Ran changed her clothes after she realized how much she had changed, and other participants stopped taking pictures of themselves after a certain moment of realization. This was not obvious in studies of body modification because when consumers engage in such consumption practices the epistemological realization and ontological changes happen almost at the same time.

**Disavowal of changed body from self making efforts and making up for deficiency through consumption**

*The changed body as a foe*

In terms of conception of the self, participants refused to accept their changed body into their idea of who they are. They tended to think that their changed body was just temporary and that they would regain the same body they had before pregnancy. With the hope for going back to the body before pregnancy, participants tend to put some distance between their self and their body. For this reason, most of them excluded their changed body from self making efforts through consumption. They especially perceived their changed body as negative, and some expressed hostile feelings to their body. In their narrative, their body was referred as something extraneous and separate from their self. These negative emotions were expressed most vividly by Ji-Young, a participant who experienced childbirth most recently.

During the last month I was like...scared. Since my belly became too big I was scared to move. Uh... I also thought something like...whether this is a human or an animal. (What
do you mean by “a human or an animal”?) That is, I got pregnant when I was kind of old. That is…in the mirror there is a person who is very different from the body image that I have had over 30 years. … The idea of being fat… I was not a person with a fat belly…And it was very different to look at my fat belly in the mirror from looking at other person’s fat belly. When I looked at my belly, what can I say…it didn’t feel like me, and feel awkward because it did not feel like me. I had some vague fear about what would happen later (with this body). (Ji-Young)

Since they had kept the hope that they could go back to their previous body, their current body was considered to be just a temporary state. This led them to engage in various activities to restore their body to the previous state. Ji-Hee read exercise books and tried to reduce sweet and fatty foods she had craved during pregnancy. Se-Ran went on a GI diet, in which people only eat foods that do not raise insulin level too much. When she could not be on diet or exercise because of her kids, Jin-Sook used fat removing cream to lose weight. However, these efforts were not so successful in losing weight and getting her previous body back. Having free time to invest on dieting and exercising was too difficult for them because their new role as mother required a lot of their time.

Frustration in Fashion Consumption

Many participants experienced difficulty in losing weight, and the body was not the same even when they lost weight over a long period of time. Jin-Sook explains how the body became different after having babies:

First of all, the stomach does not go back to the previous state. So clothes that I used to wear don’t fit well around the waist and stomach … Uh… That is, there are some parts that never go back to the previous state even when overall you get back the similar body to the previous one. (Do you have any examples?) Your pelvis becomes wider, your arms become bulkier, and your breasts become droopy because of breastfeeding and the changes of breast size. They get bigger during pregnancy and smaller after stopping breastfeeding. So other mothers often say that it does not look good on you when you wear what you used to wear even when you go back to the previous body weight. They say it looks weird somehow. (Jin-Sook)

This difficulty in getting their previous body back led to frustration in their fashion consumption. They did not fit or look well in the brands, styles or sizes that they used to wear. In addition, they did not know which new styles and sizes their new body might fit in. In the past they knew that a particular size or style looked good on them. However now they had to start again to find out which clothes would look good on their changed body. This upset them and led to the frustration in consumption experiences. Ji-Young spoke out about the difficulty that she was experiencing while shopping for clothes. She said:

Anyway I went to the mall to buy clothes because I didn’t have anything to wear. But I couldn’t choose anything. I didn’t know what to wear and what would look good on me because my present body size is too different from the past. … Now I cannot wear the designs I used to wear. … I liked tight fit with simple designs. … I cannot wear knit sweaters now because they reveal my fat stomach too clearly. I hate it so much. If I try to conceal every fat spot I will have to wear very loose clothes. But if I wear them, I look like an azumma. It becomes worse since I am a short person. So I could not decide what to buy. For instance if I wanted to buy a blouse in the past I knew that I looked pretty in a tight blouse shorter than hip length. But now I cannot wear that style now. If I wear it my chubby parts will stand out. It will not fit anyway. My shoulders are similar but my bust and waist got bigger. Originally my breasts were very small, and then after my breasts got bigger it feels like that the size is not for me even when I feel tight. (Ji-Young)
While experiencing these body changes, participants felt tensions between their retained self concept and changed body. While struggling to lose weight and restore body shape at the same time being a good mother, they stopped buying clothes. If they had to buy something, they debased their purchase. The hope of going back to their pre-pregnant body was the biggest driving force in this delaying and debasing of fashion consumption. Most of the participants felt that buying clothes to fit the current body was a waste of money when thinking of the possibility of losing their pregnancy weight soon. Especially right after childbirth the expectation of going back to the previous body was very high. They did not want to spend a lot of money to buy clothes to fit their current body. So some participants wore their husband’s clothes or maternity dresses even after childbirth. If they had to buy something, they just bought something cheap or disposable.

Making up New Body with Consumption Change

The participants started accepting their changed body since their body did not change into the previous state and the environment around them did not allow the time to invest in themselves. The most interesting thing about the acceptance is that the participants used the term “giving up” when they described their experience of accepting their new body. This implies that adapting to a new body is not accepting the changes gradually but taking an abrupt step comprised of ‘giving up’ and ‘accepting’ in terms of consumer epistemology. By saying “gave up” they meant they abandoned hope for getting their previous body back and accepted their “ruined body.”

Originally I did not care much about clothing. Buying my clothes decreased a lot. Moreover I came to buy fewer clothes because it felt wasteful to buy new clothes when you got fat and could not wear what you used to wear. Nowadays I started buying clothes again. I might say that I almost gave up. (Eun-Hee)

Now I didn’t have clothes that fit me well, so I went out wearing anything. ... At first I really wished that I would never meet someone I knew on the street. Now I think… “nothing can be done even if I meet someone on the street” and “now my body has been ruined”. (Laughing) It seems that now I start to accept it. (Ji-Young)

As time went by they accepted their changed body and they resumed their fashion consumption again. They started to apprehend how they could cover the defects of their new body. This new realization and understanding led to changes in fashion consumption. At this stage, the clothes they bought changed not only in size but also in style, brand, and retail stores. Jin-Sook started to shop for brands designed for younger generations like American Eagle even though the clothes from those brands are sometimes too tight and uncomfortable. She also avoided shopping in stores like Wal Mart because clothes from those stores made her look fat. Instead, she shopped at outlet stores in the nearby neighborhood to find good quality clothes with cheap prices.

As I am getting older, I come to prefer blue jeans more because I think that I look younger in jeans. When I was in college, I liked to dress up. But if I wear what I wore in my college years, I would completely look like an azumma. So I don’t wear those kinds of clothes any more. I only wear blue jeans. … Even though you lose all the weight you gained during pregnancy, it’s not the same especially around your stomach. For example, you have a wider pelvis, squasy and fatter upper arms, hung down breasts and so forth. So you look different and awkward when you wear the same clothes that you wore before. I also didn’t get back my former body and many things are different now. So I try to avoid tight-fitting t-shirts to make my stomach stand out and look for clothes with which I can mask my stomach. I tend to wear a few layers of clothes to hide my shortcomings and become very picky when I choose blue jeans. (Jin-Sook)
They gave up what they liked in the past and started to try new styles to cover their bodily shortcomings. Although they acknowledged and accepted their changed and unfamiliar body, they still wanted to look like their older self. As a result, they hunted for clothes to mask or cover their shortcomings. As Eun-Hee did, wearing more renowned brands was one of the ways to compensate for their ruined body.

I happened to look for good brands after childbirth. …Since I lost confidence about my body, I feel that I would like to wear some good clothes even though I don’t care much about styles. I don’t want to buy cheap ones now. … (In terms of style) I came to prefer t-shirts with long waists, and in terms of pants, I never buy without back pockets because pants without back pockets make me look fatter (Eun-Hee).

As seen in the above excerpts, they began to learn what kinds of clothes looked good on them. They came to accept the fact that in their old clothes they could not look as they wanted to look. Through trial and error, they figured out what was good for them. With the acceptance of changed body into the conception of their self, participants emphasized hiding and masking the perceived shortcomings in their body rather than attempting to keep wearing the clothes that they used to wear.

A Paired Identity and Body Project

The changes of the body brought the changes of external relationship, which is also mediated through the body (Merleau-Ponty 1962; Murphy 1987). To them the changed body was considered to be a manifestation of their changed identity as a mother. As a result participants considered their changed body as inevitable and emphasized the importance of their baby and their identity as a mother. That is, their identity as an individual woman gave way to their identity as a mother, which cannot exist without being paired with a child. They showed many behaviors of self sacrifice for their children. When they were confronted with a conflict between their personal desires and maternal duties, they almost always chose the maternal duties over their own desires even if there was an alternate option for them to use. For example, Ji-Young was seriously concerned about her body size and shape after delivery, but she could not go on a diet because she needed to breastfeed her child. Even though she could feed her baby formula instead, she did not take that action. After childbirth, her priority in life changed and the change affected her practicing of self. Recognizing a pair identity of ‘mother-child’, she gave more priority to her child's needs sacrificing her desire to go back to her previous body:

I tried to eat less for a day or two, and then my breast milk stopped flowing. So I didn’t have any choice. Of course I could use baby formula, but I didn’t want to because it’s said that babies raised with mother’s milk are healthier. I became so determined to breastfeed that I drank a whole carton of soy milk. It’s usually really greasy food that helps increase breast milk production. I ate a lot of pork belly meat. When I had that food, milk production became high for a few days. (Did you enjoy those kinds of foods originally?) No, I didn’t like them at all but I couldn’t help eating them. … Sometimes I feel sorry for myself because I have to eat although I know what will happen to my body if I eat those greasy foods. …I feel like I am not a human anymore (laughing). Now my life has become for my baby. I’m a kind of a baby food container as my mother told me jokingly (laughing)… I am worried that if I cannot lose weight, it would be very painful if I have to keep this body. But I feel less pain than before. I think that I am accepting the reality…. (Ji-Young)

Our participants gave up what they desired in many ways after gaining their identity as a mother. As seen earlier, in order to take a good care of their babies mothers sacrificed their time to invest in grooming their body and ate more food to give more breast milk to their baby although they knew that those behaviors would do harm for them to get back their previous, more desirable body. In terms of spending,
the needs for their children took priority over their own needs and wants. As Yoon-Jeong said, they changed into a person who “feels so difficult to spend $20 for herself but can spend the same $20 for her child as if it is the price of a chewing gum.” In their consumption decisions such as making up menu and using cosmetics, their foremost criteria for decision making was their children.

When I shop for meat, for my baby I buy lean tenderloin. My husband grumbles about it because it is expensive, although he’s less grumbling now. (Despite his grumbling) I just buy that one. (Eun-Hee)

I was told that drinking one or two cups of coffee was okay in pregnancy. But I just felt that it would not be okay, so I did not drink coffee during my pregnancy. And then… I was told that you should not eat hot and spicy food when you breastfed. In fact it might have been okay for me to eat hot and spicy food. I don’t know why but… elders in the family said that baby anus becomes red if the mother eats hot and spicy food. So I did not eat kimchi for a month. (Hee-Won)

It seems that I did a little bit of over-reaction. I was told that it is not good to apply too much cosmetics having retinol. As a matter of fact I heard that only wrinkle care products have retinol as an ingredient. But I was so worried that retinol might be absorbed through my skin (into the baby). So I barely put makeup on. I did not apply even skin toner and moisturizing lotion. (Se-Ran)

About this kind of sacrifice that they had to make they expressed some negative feelings. They felt sorry that they had to sacrifice what they wanted and felt sad about giving up the self as an individual woman. Ji-Young made a joke about herself saying that she felt like she was a “baby food container.” The grievance for their older self is shown very well in the following quotes from Yoon-Jeong:

Ah… (I felt that) my life has really ended. …When I think that I will be tied up to the baby while my future has not been determined yet, I felt gloomy. When hormones fluctuated, my eyes were in tears without reasons. I think that it was some kind of fear for my life as a hostage of my baby. (Yoon-Jeong)

Despite the grievance over their older self, they also took pride in their sacrifice and maternal love. The pride that these women expressed implies that their sacrifices might not necessarily be the relinquishment of self construction. It is true that they were giving up their desire to be an attractive woman as they used to be. At the same time, however, they were engaging in the process of constructing maternal identity. In particular, Yoon-Jeong expressed the joy of raising a child vigorously although she felt that her life was as a hostage of her baby, and Hee-Won also expresses the wonder of knowing what the maternal love is:

(I cannot believe that) I had a baby and gave birth to him. Although I only fed him my breast milk, he put on weight and now starts to speak. … I did not know that I could raise a baby like that. He’s so lovely even when he cries and teases me. Maybe it’s because I had a baby in old age. (Yoon-Jeong)

Before pregnancy I didn’t know what maternal love was. …But after I had the baby in my stomach I could feel maternal love even before delivery. For instance when something dangerous happened to me, I tended to cover my stomach. Looking at myself protecting baby before me, I felt that I had so called maternal love too. (Hee-Won)
Unlike the identity construction at an individual level that people usually focus on their own wants and needs, the participants put their baby’s needs and wants before their own. As seen earlier although she could feed baby formula instead of breast milk and be on a diet in order to lose her pregnancy weight, Ji-Young chose to keep feeding breast milk to her child. Every participant said that they tried to buy better quality food for their children while they did not care much for their own food. These examples illustrate a unconventional way of self construction in which consumers construct their paired identity as a mother by sacrificing self construction at an individual level.

**Korean Women Situated in the American Culture**

The participants stated that their experience of weight gain would be very different if they were in Korea, where the social pressure on women being thin is more severe than in the U.S. Most of them mentioned that they could not have worn what they actually wore after childbirth and went out if they were in Korea. They felt relieved that they were staying in the U.S. because the individual culture of America enabled them to be less conscious about their appearance and to be more carefree. Eun-Hee expresses such a relief mentioning her experience in Korea:

"I think that America spoiled me, not in a bad sense though. In America, I can be very comfortable in public wearing something like jeans, jumpers and slippers. It seems that I became lazier because of the comfortable atmosphere of America. If I were in Korea, I would not be like this. … My family members in Korea always say, “Why do you live like that? Please don’t do that.” But I am still the same. Because it’s too comfortable, I don’t want to change it at all. I don’t know… I might have to change myself if I go back to Korea for good and live there (Eun-Hee)"

As these quotes show, the culture in which people are situated plays an important role in their body project and self making practices. Our participants might have behaved differently in terms of their body management and fashion if they were situated in a different social context. Jin-Sook, who experienced pregnancy and childbirth both in Korea and the U.S., said that she was more stressful about what to wear and how she looked in Korea than in the U.S.

"When I was in Korea, I got a lot of stress because there were no clothes to wear even though I had to dress up for going out. Here there was nothing like that. Here everybody wear comfortable clothes, so I did not get much stress. (Jin-Sook)"

Visiting family members in Korea reminded them that there are big differences about social norms about fashion and their body. Eun-Hee’s experience with her family in Korea explicitly illustrates this:

"I got hurt a lot (when I visited my family in Korea). My father was hard on me being fat every day. Except for my mother. My mother did not say anything because I would retort her if she said something like what my father said. Other family members were so mean because I got fat. I came back from Korea crying bitter tears. Especially my older sister nagged me so much. The person who got fat is the most stressful than anybody, isn’t it? I said to her to stop but she did not listen to me, so I got very angry. I begged her to please stop. I fought with her. I was that much stressful when I visited Korea. My sister told me that nowadays in Korea the most detested are fat people. (Eun-Hee)"

In a collectivist culture like Korea, participants had to worry more about their appearance such as their weight, body shape and fashion. However the same women felt that they did not have to care much about what they wear and how they look in the U.S., where the culture is more individualistic and people do not care much about how other strangers look. This finding supports the idea that the cultural context in which consumers are situated plays a very important role in engaging in various body management.
regimes. Although many critics have pointed out that an unrealistic thin body ideal oppresses women in America, ironically Korean women felt liberated in American culture because the collectivist culture of Korea had imposed more monolithic social norms on women’s beauty.

**DISCUSSIONS**

**The Body in Consumer Subjectivity**

*Living with the Subject Body*

Participants experienced various body changes such as morning sickness, cravings, highly stimulated appetite, weight gain, stretch marks, prenatal diabetes and ruined body shape, which had occurred naturally as pregnancy progressed. In undergoing these changes our participants did not have much control over their body. On the contrary, these disruptive changes dominated their lives as seen in the cases of Yoon-Jung and Ji-Young, who experienced severe morning sickness and extended bed rest. Experiencing these uncontrollable body changes shook taken-for-granted assumptions about possessing a smoothly functioning body. (Charmaz 1995). This shows that our body is not necessarily an object being acted upon by the mind but a self-acting subject. Figure 1 illustrates how body changes lead to the changes in the dynamics of the body and the self, and in consumption.

To cope with the situation, our participants put distance between their self and their changed body. They refused to incorporate such an uncontrollable self-acting body into their identity construction process. Participants have also become emotionally detached from their body (Murphy 1987). Emotions such as irritation, fear, and anger were expressed quite often when they described their changed body. The expressions like ‘animal’ and ‘this is not me’ clearly indicate this refusal to accept their changed body as their own. Understanding their coping through disembodiment seems to be important matter considering that this phenomenon happens quite often in consumers’ coping process of physical difficulties as seen in aging, being chronically ill or disabled. It has been reported that the disembodied self (Murphy 1987) is quite common among patients with chronic illness and disabilities and these patients usually claim that
they are more than their body and there exists the same self inside of it (Charmaz 1995; Corbin 2003). As seen in the research of Thompson and Hirschman (1995), even consumers who do not experience severe disruptive body changes were also distancing their self from their body by utilizing the discourse of body/mind dualism to acquire the sense of control in their life by disavowing their body in defining their identity and self construction efforts.

In terms of consumption this disembodied self led to the suspension or debasing of fashion consumption. In this suspending or debasing of fashion consumption, the emotion of hope played a crucial role. They thought their changed body to be a temporary state and hoped that they could get back their previous body after childbirth. This hope made them postpone their new fashion consumption. They engaged in certain types of consumption practices instead such as dieting, exercising, and applying fat removing cream, and this clearly supports the notion that the marketplace provides a source of hope to consumers (de Mello and MacInnis 2005). At the same time, however, our participants retreated from the marketplace of fashion due to the hope of getting back their previous body. This indicates that the emotion of hope interacts with the disembodied self in a more complex way in the marketplace than the marketplace only being a source of hope to consumers.

Later, the participants began to accept their new bodily shortcomings as their own and started to buy clothes that helped them to hide or mask those shortcomings. As re-embodifying their self, they learned how certain types, styles or brands could make their bodily shortcomings stand out or be obscured and made purchase decisions based on such learning. It seems that our participants chose to coexist with their changed body peacefully rather than taking drastic measures to take control over their body. With the intention to take control over their body, many people engage in consumption practices such as plastic surgery and try to make their body in accordance with their ideal of the self (Askegaard, Gertsen, and Langer 2002; Schouten 1991) and this is quite an important aspect of self construction of consumers. In reality, however, more consumers than not choose to coexist with their troubled body rather than to take extreme action. Moreover, in terms of various body changes with the deterioration of bodily functions, there is not much room for taking control of one’s own body. For this reason, investigating the peaceful coexistence with our subject body especially has great relevance for elderly consumers and medical consumption research. The experience of Yoon-Jeong who had prenatal diabetes clearly demonstrates this point. During her pregnancy, she had to be very careful about what she ate and how much she ate to regulate her blood sugar. By regulating her eating she could undergo her pregnancy without a great deal of trouble. She learned her body’s peculiarities and how to handle them. This must have given her a sense of control over her body. However we cannot conclude decisively that she finally took control over her body with her strict diet just because her symptoms were dormant. For her ailment of prenatal diabetes was still there even though the symptoms were not active, and they were very likely to intensify at any time unless she followed her doctor’s directions very carefully.

Our body changes everyday. Even for very healthy people, the deterioration of bodily functions is unavoidable as they get older. Being taken ill or experiencing accidents also can bring about unexpected negative changes to our body. These bodily changes are very different from the aesthetic enhancement of the human body through various body modification practices. They are almost always negative and damage to the integrity of an individual in many cases. Generalizing self-body dynamics of body modification to all body changes, therefore, does not seem to be beneficial to understanding a variety of negative changes in our body. By paying attention to the aspect of the subject body, consumer researchers will be able to bestow more agency to the body and better understand the interplay between consumer body and mind.

Unsynchronized Relationship between Consumer Ontology and Epistemology

The world out there without our being conscious of it is a not meaningful reality to us because we do not have any knowledge about it (Crotty 1998). Similarly without being conscious of a changed condition
of one’s being in the world (Murphy 1987) or one’s changed ontology, the changes do not have meanings for consumers. By acknowledging the body as subject, researchers can examine this interplay between the consumer ontology and epistemology. This is possible because our body acts by itself regardless of whether we are conscious of its change, and the time lag exists until we can perceive the changes of our subject body and make a decision of how to cope with our changed body. Only after realizing their changed ontology, can consumers take various actions such as undergoing plastic surgery or enduring with their troubled body. Even consumers who underwent various aesthetic plastic surgery procedures are most likely to have experienced a time lag between their change in ontology and epistemology before the making decision to undergo the operation. However most of body modification studies have examined the very body changes directly induced by body modification practices, in which the changes in ontology and epistemology are almost synchronized. As a result, researchers tended to overlook the time lag between the ontology and epistemology of consumers.

By focusing on naturally occurring bodily changes the present study demonstrated that consumers might not perceive their body changes at the same time they experience bodily changes. The participants anticipated body changes during pregnancy and after childbirth, so it was not totally unexpected. However the extent and the intensity of changes were truly unexpected. Moreover, our participants could not realize the meanings of such changes in terms of their self definition until a certain moment finally came. The cognitive knowledge of gaining 30 pounds is very different from understanding the meaning of gaining 30 pounds by confronting themselves through the reflection in the mirror or their image in photos. When they finally realized the meaning of these changes, the changes in consumption began to emerge.

Philosophically speaking their changed body could not be separated from their self as Merleau Ponty (1962) says. However, in reality they did not realize the fact that they have changed in terms of their ontology until a certain moment came. This means that the body changes might have been happening bit by bit but the realization of such body changes is often a disruptive experience. For instance, Se-Ran kept wearing her husband t-shirts until she realized how much she had changed and how awful she looked in them. She somehow knew that she gained some weight compared to before pregnancy. However she did not really know the meaning of her changed body until she saw the reflection of hersel wearing her husband’s boxy t-shirt. Ultimately the ontological changes of consumers led to consumption change, but the important thing to point out here is that the moment of consumption change comes with the epistemological change of a consumer rather than right at the moment that the ontological changes are happening.

This difference between the two selves could come to our attention by examining naturally occurring body changes during and after pregnancy. Considering all people experience various natural body changes in their life stages such as puberty, aging, menopause, and chronic illness posits the importance of differentiating the influence of ontological self and epistemological self on consumption.

### Relational self and Body Project

Traditionally in consumer studies “self” has been conceptualized as a mental representation of oneself at the individual level without paying attention to the relational identity of consumers. Some exceptions existed in terms of examining collective consumption of family members (Epp and Price 2008; Thompson 1996). However body related consumptions have been considered to be very personal and usually studied at the individual level without considering the relational aspect of self. Indeed, articles on various body modification practices have left traces of the influence of relational self on an individual consumer’s body project. For instance Schouten (1991) reported that his participants could have a better romantic relationship with their spouses after surgery and a participant of Velliquette et al. (2006) had a tattoo put on to remember his dead wife. Very often social pressure on individual consumers or consideration is mentioned as important factors in the decision making of undergoing various aesthetic body modification practices (Askegaard, Gertsen, and Langer 2002; Sayre 1999). However, in these
cases, although social relations influenced their decision of taking body modification practices, the relational aspect of the self did not intervene into the practices of body project. In the case of our participants engaging in body project directly contradicted with their practicing of maternal identity as seen in the case of Ji-Young, who had to make the choice of abandoning a diet in order to choose breastfeeding. This finding supports that our body is an embodiment of a set of relationships that link the outer world and our mind (Beauvoir 1952; Merleau-Ponty 1962; Murphy 1987) and also indicates that the relational self is working even at the utmost individual level of consumption.

The intervention of the relational self into the body project of consumers and their sacrificing behaviors for their significant others or their children in this case also extends the Thompson’s (1996) understanding of caring consumers. If self sacrificial behaviors of participants are seen from the individual identity perspective, these consumers may be regarded as not participating in constructing self identity. However when we look at these sacrificial behaviors from the perspective of maternal identity, we can see that they are still actively engaging in constructing their self through caring consumption. In order to construct their self identity consumers usually spend the money and time for them. Paradoxically, however, our participants engaged in the self construction process by not spending resources for them by showing that people can construct their identity by sacrificing their desires and put others’ needs and wants ahead.

This finding suggests that consumer researchers cannot fully understand consumers’ identity construction process even at the utmost personal level without considering relational identity. By saying this we do not mean that people have multiple identities and a particular identity is enacted in a particular situation (Jain, Desai, and Huifang 2007; Schenk and Holman 1980). In our study maternal identity and individual identity are always active at the same time and they have different interests in terms of the participants’ body project. At the individual level, having an attractive body is important and this requires these women to engage in activities including dieting and exercising. At the relational level, taking good care of their baby has the utmost importance and this requires our participants to devote their resources to their children. For instance, the identities as a mother and an individual woman clashed when Ji-Young had to make a decision between feeding baby formula to go on a diet and eating greasy food to feed her breast milk to her baby, and she made the decision to putting her baby’s needs and wants before her desires to get the previous body back. In other words, she chose to sacrifice individual identity construction to establish her maternal identity. This paradoxical way of identity construction through self sacrifice definitely suggests that it is necessary to widen the definition of the self so that it can incorporate this relational aspect of self making.

**Managerial Implications**

We showed that consumers stopped their fashion consumption or debased the quality of it when they felt disruption between their real body and the ideal conception of their body. It took a substantial amount of time until they gave up going back to their previous or more desirable body and resumed fashion consumption. This finding poses a question to current fashion advertising practices using unrealistically thin models.

Almost every fashion advertisement promotes their product by showing models with unrealistically thin bodies. Although the fashion industry has started to embrace plus size models, extremely thin models still dominate in the industry. The motive behind these fashion advertisements would be to sell more products by making consumers long to be like them. Identity of a fashion brand is established through these fashion images and consumers make their identity statement by mixing and matching these fashion items. It is quite well known that elite fashion companies make their profits from other products such as selling perfumes and leasing licenses and that fashionable clothing shown on the magazine pages or on the runway is just a means of building and maintaining brand image (Crane 1999; Tungate 2005). As one of Thompson and Haytko’s (1997) participants said, consumers can fantasize that they wear clothes
shown in a fashion magazine, and it might motivate them to engage in dieting and to be careful about what to wear in their everyday life. It is also possible that consumers who cannot wear the clothes shown in the magazines can buy the perfumes and contribute to the revenues of a company. At least for luxury fashion companies this strategy can be viable. However, the marketing practices of elite fashion companies trickle down to the industrial fashion companies, which should sell more clothes to get profits. As our study has shown, when consumers feel that the gap between their actual body and their desired body is too big, they might not fantasize wearing those clothes anymore and suspend purchasing new clothes until getting the body they want and endure with the clothes they already have.

We can think of the possibility that these consumers will buy more clothes after they become successful in their dieting and get the body they want. This is a very plausible scenario if one’s body is just an object that can be controlled by one’s mind. As our research findings show, however, our body is a self-acting subject as well as an object. Moreover, in reality it is more likely to fail to lose weight than to succeed in dieting. Even when they succeed in losing weight, it is easy to gain weight again. Considering that people rarely buy new or good clothes when they engage in various consumption practices to sculpt their body, it does not seem to be a desirable situation because consumers would not buy any clothes for quite a long time if they continues to go on a diet until they achieve their ideal body. This situation is not desirable for the fashion industry which wants to sell more new clothes. Considering increasingly faster fashion cycles (Turngate 2005), the suspension of fashion consumption due to the discrepancy between reality and fashion images might pose a more serious problem to the fashion industry. Our research findings suggest, therefore, that closing the gap between the body of general consumers and fashion images by using models of various sizes would be more profitable for fashion companies than keeping the current practice of using fashion models with unrealistic bodies.
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SOCIAL CAPITAL TRANSFER AND PERFORMANCE IN FRANCHISING

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ABSTRACT

This paper examines the role of franchisees’ social capital with customers for the performance development of new franchising ventures. Entrepreneurs that can transfer customers from their former occupation into the franchise arrangement have a starting advantage, since an established customer base provides some “certain” sales and referrals. Using panel data from 175 outlets, the empirical analysis shows a strong connection between a franchisee’s customer capital and short-term performance after system entry. Effects are even stronger if franchisees understand utilizing customer relationships as a source of information. However, benefits of transferred customers cease over time as others catch up in acquiring customers and know-how.

INTRODUCTION

“Just as for a child, the conditions under which an organization is born and the course of its development in infancy have important consequences for its later life” (Boeker, 1989, p. 490)

The franchise system of distribution better suits the needs of some prospective entrepreneurs than others. Some franchisees prosper, stay within their system, and make major contributions to the system’s success – other franchisees fail in all areas (Jambulingam and Nevin, 1999). Only a small proportion of entrepreneurs has the potential for substantial wealth creation (Birley and Westhead, 1994; Cooper et al., 1994; Gilbert et al., 2006; Reynolds, 1987). Chains would greatly benefit if franchisors were more able to detect future high-performing franchisees in the pool of applicants and accept them into the system, rather than low performers (Jambulingam and Nevin, 1999). Yet, to date, although franchisees are an essential ingredient in successful chains and franchising is so important in today’s economy, few studies have analysed the determinants of franchisee performance (Dant, 2008; Michael and Combs, 2008). This paper addresses the question of what makes a franchisee successful.

The entrepreneurship literature has long assumed that entrepreneurial success can be attributed to some set of demographic factors, personality traits, or psychological variables that hold across different contexts (De Carolis and Saparito, 2006; Low and Abrahamson, 1997). But as equivocal research results show, most characteristics are context-dependent, thus have different effects on performance in different environments. Another stream of research emphasises the importance of networks, and the social capital inherent in them, for new firms (Aldrich and Zimmer, 1986). Social capital is “the sum of the actual and potential resources embedded within, available through, and derived from the network of relationships possessed by an individual” (Nahapiet and Ghoshal, 1998, p. 243) that creates “entrepreneurial opportunities for certain players and not for others” (Burt, 1992, p. 7). Yet, as De Carolis et al. (2009) point out, not all well-connected, aspiring entrepreneurs are able to successfully launch a business. Thus, relationships differ in their usefulness for reaching entrepreneurial ends (Combs and Ketchen, 1999). Focusing on performance ends, of all the social capital firms have in terms of relationships with other actors, customer relationships are the most central to their profit generating purpose (Gupta et al., 2004; Srivastava et al., 1998; Yli-Renko and Janakiraman, 2008).

Drawing on De Carolis et al.’s (2009) and De Carolis and Saparito’s (2006) work on the impact of social capital and personal factors in exploiting entrepreneurial opportunities, and on De Clercq and Rangarajan’s (2008) and Reuber and Fischer’s (2005) work on how customer relationships affect new firms, this study focuses on social capital with customers for explaining start-up success. The thinking is that positive effects of a steady inflow of customers are less context-dependent than other factors’ effects.
In customer relationships, entrepreneurs build up reputation (Reuber and Fischer, 2005). The value of a good reputation and social ties with customers is the following: first, a good reputation motivates customers to continue a relationship with a firm (Dollinger et al., 1997). Second, social ties transfer expectations about people’s behaviour from a prior social setting to a new business transaction (Shane and Cable, 2002; Uzzi, 1996). Following these insights, the idea is that entrepreneurs can use their customer relationships – those that they have built in another occupation, prior to system entry – as an asset for starting as a franchisee. Entrepreneurs who can transfer customers from their previous into their subsequent occupation have a starting advantage, since an established customer base provides “certain” sales and referrals. Here, “social capital transfer” describes the entrepreneur’s ability to transfer social capital in terms of customer relationships into the franchise arrangement.

Consistent with the literature on how entrepreneurs use relationships for competitive advantage, this study is based on the premise that economic explanations for entrepreneurial success are incomplete and undersocialized. By combining the literature on social capital and new venture performance for the franchising context, this paper makes several contributions. First, it extends research on franchisee performance (Dant, 2008; Michael and Combs, 2008). Second, prior studies on new firms’ relationships with customers examine primarily technology-based firms (Yli-Renko and Janakiraman, 2008) and selected relationships like “key customers” (Abratt and Kelly, 2002; De Clercq and Rangarajan, 2008; Venkataraman et al., 1990; Yli-Renko et al., 2001a; Yli-Renko et al., 2001b), and do neither address transfer of social capital nor consider the franchising context. Thus, this study adds to the broader discourse on the role of customer relationships for start-up performance and development. Third, the few empirical studies on franchisee selection (Altinay and Miles, 2006; Clarkin and Swavely, 2006; Wang and Altinay, 2008; Williams, 1999) provide little evidence for how to select potentially better performing franchisees (Birley and Westhead, 1994; Jambulingam and Nevin, 1999; Saraogi, 2009). The results offer some implications for more successful selection. The next section outlines the literature on entrepreneurial performance and social capital with customers. Then, hypotheses on performance effects of social capital transfer are developed. In section 4 data and methods are described, section 5 reports the results. Section 6 concludes.

THEORETICAL BACKGROUND AND HYPOTHESES

To date, few studies have analysed the determinants of franchisee performance (Dant, 2008). Research has addressed the exploitation of entrepreneurial opportunities in terms of starting a franchised or an independent firm, but little is known about the success of these exploitation attempts (De Carolis and Saparito, 2006; Kaufmann, 1999; Lumpkin and Lichtenstein, 2005; Williams, 1999).

However, studies have analysed performance differences among independent founders. The belief that the entrepreneurial firm is an extension of the entrepreneur has led many researchers to examine the entrepreneur’s personal characteristics (Gilbert et al., 2006). A plethora of factors has been considered (e.g. Box, White and Barr, 1993; Cooper et al., 1994; Davidson and Honig, 2003; Ensley et al., 2002; Sapienza and Grimm, 1997; Shrader and Siegel, 2007; Siegel et al., 1993; Vanaelst et al., 2006). Demographic studies examine characteristics like the entrepreneur’s age, gender, family background, education and experience. Personality and psychological studies examine variables like the need for achievement, risk aversion, self-reliance, values and beliefs. Behavioural studies consider behaviour and decision-making based on communicative, managerial, manufacturing, marketing, organisational, or technical skills (Chrisman et al., 1998; Gilbert et al., 2006; Shrader and Siegel, 2007). By examining these factors, research demonstrates that entrepreneurs are in fact heterogeneous. Yet, results concerning the link between these factors and performance (in terms of sales, growth, ROI, or survival e.g.) are ambiguous, since the performance impact of many factors is context-dependent (Low and Abrahamson, 1997; Newbert, 2005; Shrader and Siegel, 2007; West and Noel, 2009). Factors that lead to success in one context can lead to failure in another, which may also apply to franchising ventures (Low and Abrahamson, 1997). Still, identifying potentially better performing franchisees is central to each chain’s
prospects in the marketplace. Jambulingam and Nevin (1999, p. 364) argue, “the ideal in building and maintaining a high quality network of franchisees is a selection method that would qualify prospective franchisees based on their likely future performance”.

Another stream of research emphasises the importance of networks, and the social capital inherent in them, for new firms (Aldrich and Zimmer, 1986). Low and Abrahamson (1997, p. 437) point out that “entrepreneurship is a social process”, where organisations emerge because critical stakeholders commit to the organisation’s concept and their support is required for venture success. Researchers use the notion of social capital to refer both to the relationships that exist among individuals and to the assets that are mobilised through social relationships (Burt, 1992; Gant et al., 2002; Nahapiet and Ghoshal, 1998; Putnam, 1993). Burt (1992, p. 7) links social capital and performance by characterizing social capital as a resource that creates an advantage in “the way in which social structure renders competition imperfect by creating entrepreneurial opportunities for certain players and not for others” and brings a higher rate of return on investments. Both the entrepreneurship (Aldrich and Zimmer, 1986; Uzzi, 1996; Walker et al., 1997) and the social capital literature (Adler and Kwon, 2002; Burt, 1992; De Carolis and Saporito, 2006; Nahapiet and Ghoshal, 1998; Tsai and Ghoshal, 1998) emphasise the importance of social capital as the primary link to resources necessary for firm survival and growth (Morse et al., 2007).

Social capital can enhance performance directly by providing entrepreneurs with access to information, financial capital, emotional support, legitimacy, or competitive capabilities, and can offer indirect benefits by leveraging the productivity of internal resources (Florin et al., 2003; Stam and Elfring, 2008).

Yet, as De Carolis et al. (2009) point out, not all well-connected, aspiring entrepreneurs are able to successfully launch a business. So, social capital is not universally beneficial for performance either – for example, because of investments involved in building and maintaining relationships, or since available resources are redundant or irrelevant (Adler and Kwon, 2002; Nahapiet and Ghoshal, 1998; Nasrallah et al., 2003; Uzzi, 1996). As Adler and Kwon (2002, p. 26) observe, “In life we cannot expect to derive any value from social ties to actors who lack the ability to help us”. Hence, relationships differ in their usefulness for reaching entrepreneurial ends.

Focusing on performance ends, of all the social capital firms have in terms of relationships with other actors, customer relationships are the most central to their profit generating purpose (Gupta et al., 2004; Srivastava et al., 1998; Yli-Renkonen and Janakiraman, 2008). Often, relationships provide potential benefits only (Srivastava et al., 1998), meaning obtainable resources – like information access, emotional support, or legitimacy – explain performance only to the extent that organisations capture the economic value that they create (Crook et al., 2008). Yet, resources obtainable from relationships with customers in terms of revenues provide actual benefits to the entrepreneur (in addition to potential benefits like access to information that the entrepreneur may be able to exploit and convert into revenues in the future). Thus,

1 Empirical studies on franchisee selection criteria focus on demographic factors like age and business or industry experience, personality, or financial strength (Altinay and Miles, 2006; Clarkin and Swavelley, 2006; Jambulingam and Nevin, 1999; Wang and Altinay, 2008; Williams, 1998). Yet, there is little empirical support for which criteria lead to the desired results (Birley and Westhead, 1994; Jambulingam and Nevin, 1999; Saraogi, 2009). Successful franchisee selection calls for further research (Clarkin and Swavelley, 2006; Saraogi, 2009; Wang and Altinay, 2008).

2 Two mechanisms explain why social ties provide access to resources under information asymmetry (Podolny, 1994). First, ties create social obligations that cause parties to behave generously towards each other (Gulati, 1995). Second, decision makers may be interested in preserving the exchange of private information, to be able to remove some ambiguity from decisions (Burt, 1992). The first rationale offers a socialized view of decision-making; the second is consistent with a self-interested perspective.

3 “A given form of social capital that is valuable in facilitating certain actions may be useless or even harmful for others” (Coleman, 1990, p. 302).
social capital with customers is relevant for performance across multiple contexts. Research shows that social capital in terms of customer relationships and the assets mobilised thereby, “customer capital” (Bontis, 1999; Duffy, 2000; St-Onge, 1996), serves as a barrier against customer switching (Jones et al., 2000). Reichheld (1996) identifies six economic benefits of retaining customers: (1) savings on customers’ acquisition or replacement costs, (2) guaranteed base profits as existing customers are likely to have a minimum spend per period, (3) growth in per-customer revenue as over time, existing customers are likely to earn more, have more varied needs and spend more, (4) reductions in relative operating costs as firms can spread costs over more customers and over a longer period, (5) free of charge referrals of new customers from existing customers, and (6) price premiums as existing customers do not usually wait for promotions before deciding to purchase, particular with new versions of products. Thus, sustained customer relationships increase performance (Dawkins and Reichheld, 1990; Reichheld, 1996).

In customer relationships, over time, the entrepreneur can build a reputation (Wickham, 2001). Reputation is the extent to which an actor is held in high regard by external stakeholders and is determined by the value of the actor’s previous efforts (Fischer and Reuber, 2007; Roberts and Dowling, 2002). A well-reputed firm is believed to have the ability and willingness to maintain promised quality standards (Erdem and Swait, 2004). Two basic insights on the value of reputation and ties with customers are that first, a good reputation motivates customers to continue a relationship with a firm (Dollinger et al., 1997), and second, social ties between parties transfer expectations about people’s behaviour from a prior social setting to a new business transaction (Shane and Cable, 2002; Uzzi, 1996).

Building on these insights, the idea is that entrepreneurs can use customer relationships that they have established in another occupation, prior to system entry, as an asset for starting as a franchisee. Entrepreneurs who can transfer customers from the previous into their subsequent occupation have a starting advantage, since an established customer base provides “certain” sales and referrals. Here, “social capital transfer” describes the entrepreneur’s ability to transfer social capital in terms of customer relationships into the franchise arrangement. Social capital transfer can occur because there are information asymmetries in markets. Entrepreneurs possess information about their business that others do not. Customers face risks when selecting among firms as firms vary in the ability to provide good service and may act opportunistically towards them. If the entrepreneur has met customer expectations particularly well before, customers may choose to continue patronizing the entrepreneur after start-up rather than the entrepreneur’s former firm.

There is anecdotal evidence that customers in fact follow a seller when the seller leaves the firm and starts in or founds another. The first customer of SAP, the British chemical company ICI, was previously an IBM customer that had been served by a member of the SAP founders’ team at IBM. When the Saatchi brothers left Saatchie & Saatchi and founded M & C Saatchi in 1995, they took along top clients. In 2000, UTA Telecom followed their creative advisors from Lintas to BBDO. One (telecommunications) and mobilcom austria accompanied creative directors who had served them before to new agencies. Marketing Director S. Mathony (Booz & Company) states, “Giving up a cooperation involves risks. Thus, for some customers, it is worthwhile to follow a trusted seller” when this seller moves to another firm (extradienst, 2009, p. 4; translated from German). Similarly, Bolton et al. (2004) note that in the insurance industry,

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4 Sveiby (1989; 1997) pioneers the inclusion of customer capital as intangible assets of firms. He classifies three customer types according to their contributions to value creation. The first type improves employees’ learning and ideas; the second enhances external structure through referrals to new customers or establishment of prestige; the third enhances the internal structure through leveraging R&D or knowledge transfer.

5 In advertising, customers are often more loyal to those who handle the customer contact than to the creative personnel, because the latter produce unobservable input, but the contact persons work directly alongside the customer. Customer transfer enhances sellers’ career prospects, “With a big budget up his sleeve, a newcomer [...]
customers are often more loyal to the salesperson than to the company. Cooper and Dunkelberg (1986) find that entrepreneurs are oriented towards the same or similar customers like their former firms, and often stay in the same geographical area, which facilitates customer transfer.

Benefits of sustained customer relationships can be even stronger when customers provide critical information (Shane and Venkataraman, 2000). Social capital with customers can enhance the entrepreneur’s ability to obtain (nonpublic) information by offering better timing, relevance, and quality of information and lower information-gathering costs (Adler and Kwon, 2002; Burt, 1992; Nahapiet and Ghoshal, 1998; Podolny, 1994; Uzzi, 1996). For example, customers can refine entrepreneurs’ knowledge about customer preferences which helps to provide satisfactory services (Gupta and Zeithaml, 2006; Ramani and Kumar, 2008; Rayport and Jaworski, 2005; Srinivasan et al., 2002). Customers also provide information to other consumers, as they tend to spread word of mouth if they feel good about the relationship with a firm and believe that a firm offers economic value (Ramani and Kumar, 2008; Reichheld, 2006). Thereby, they bring in new customers.

H1a: Social capital transfer enhances franchisee start-up performance.

H1b: The effect of social capital transfer on performance is stronger if customers serve as an important source of information.

Initial resources may predispose entrepreneurs to certain paths or equip them with unequal abilities to meet challenges, but they do not predetermine the future. Rather, the subsequent unfolding of events, including key decisions and management practices of the entrepreneur, shapes the new firm’s performance (Cooper et al., 1994). Yet, reputation differences are quite stable over time, and an entrepreneur’s good reputation with customers is difficult to replicate in the short term (Fischer and Reuber, 2007; Roberts and Dowling, 2002). So, a good reputation with customers at start-up may bind customers over a longer term, with all the positive effects of customer retention on performance. The reputation-performance-effect may even operate in both directions (McGuire et al., 1990): a firm’s reputation with its customers increases its performance and in turn, sound performance affects its reputation positively, which reinforces existing relationships and helps to attract more and more new customers. Then, social capital transfer is not just a starting advantage, but a lasting advantage.

H2: Social capital transfer enhances franchisee long-term performance.

**SAMPLE, VARIABLES, AND METHODS**

**Sample**

The sample comprises 175 franchisees of two chains in pet retail and pet supplies. Retail is the largest German industry in franchising (in 2008 sales, 36%). The context selected for the study possesses multiple desired characteristics, including customer motivation, uncertainty and experience properties. Fischer and Reuber (2007) argue that consumers are motivated to pay closer attention to a firm when they perceive that important outcomes depend on it. The sample context is a high-motivation context because of the emotional component involved for consumers. So, customers are motivated to monitor the seller’s efforts. The seller’s efforts are particularly important in industries that are characterized by consumer uncertainty. The sample context is characterized by uncertainty because quality differences in the offering has a different standing and different [i.e. much better] career prospects” (extradienst, 2009, p. 4; translated from German).

They further point out that in high-motivation contexts, a firm’s individual reputation is more important than the overall reputation of the category to which the firm belongs. So the entrepreneur’s reputation can count more than the franchisor’s reputation. Additionally, franchisor reputation is the same for all franchisees, so differences depend on the entrepreneur.
may initially be hard to spot, but consumers will learn about the quality of their purchase later. This study
prefers a consequential context because risk-free exchanges are less relevant to trust development and
reputation-building, and it prefers an experience context because such contexts enable consumers to
observe and evaluate behaviours of sellers (Sirdeshmukh et al., 2002). Thus, in the sample context,
consumers have both the motivation and the opportunity to decide to stick to a seller because of
previously satisfactory services. As there are industry-specific effects on performance (Short et al., 2007),
this research focuses on a single industry to control for that fact.

Common wisdom holds that industry experience is not essential for franchisees as the franchisor
provides training and support. Yet, transfer will rather occur when entrepreneurs are in the same industry
as their former firm. Many sample franchisees (51%) have been active in the industry before system
entry. Thus, the context provides a good background for analysing the hypotheses.

The first (second) system was founded in 1994 (2004) and has 230 (25) franchisees. Self-
administered postal questionnaires with a letter assuring franchisees of anonymity and a university
address for responses were distributed among all outlets in late 2007. The formulation of the
questionnaire items emerged from a qualitative-explorative pre-study involving franchisors, consultants,
and franchisee focus groups. Responses arrived until February 2008. In four rounds of follow-up calls,
non-respondents were contacted for telephone interviews. The response rate is 65% (100%) in the first
(second) system. In case of multiple ownership, franchisees were asked to focus on their first outlet.7 For
the first system, the study includes data from a larger project on franchisor quality by the International
Centre for Franchising and Cooperation. This data enables to track system development and conduct more
stringent tests on sample representativeness (see also Chrisman et al., 2002; Chrisman and McMullan,
2000). Due to missing data, the analysis is based on 157 franchisees.

Dependent Variables
Research suggests that capturing the multidimensionality of new firm performance requires
objective and subjective measures to achieve triangulation (Baron and Tang, 2009; Brush and
Vanderwerf, 1992; Chandler and Hanks, 1993; Stam and Elfring, 2008; Zahra et al., 2002). So, this study
uses both.

Following Zahra et al. (2002), this study uses the objective performance criteria of total sales and
growth. Sales are the most common indicator of new venture performance (Birley and Westhead, 1994;
Brush and Vanderwerf, 1992; Cooper et al., 1989; Dess and Robinson, 1984; Gilbert et al., 2006; Roberts
and Dowling, 2002; Stam and Elfring, 2008). Although sales volume is only a short-term measure of a
store’s competitive strength, long-term implications suggest a strong linkage of sales and profitability
(Buzzell and Gale, 1987). The most common indicators of new venture growth are growth in sales,
employment, and market share (Gilbert et al., 2006). Empirical studies show strong links among these
measures (Baron and Tang, 2009). Following Amason et al. (2006), Chrisman and Leslie (1989), Covin et
al. (2006), Covin et al. (1999); Florin et al. (2003), and Sapienza et al. (1988), this research uses sales
growth, which is consistent with previous research on network forms of organisations (Collins and Clark,
2003; Lee et al., 2001; Park and Luo, 2001; Sarkar et al., 2001; Singh and Mitchell, 2005; Stuart, 2000).

For measuring sales and growth, respondents filled in a series of blanks, as done in prior studies
(Zahra, 1996b, 1996c; Zahra and Bogner, 2000; Zahra et al., 2002). Brush and Vanderwerf (1992) and
Chandler and Hanks (1993) establish high accuracy and reliability of such founder reported performance
data. Franchisees were asked for sales volume for one year after start-up, for analysing the short-term
effect of social capital transfer. For addressing lasting effects, a three year time lag is chosen, in line with

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7 Some research on customer relationships in entrepreneurial contexts (Reuber and Fischer, 2005; Yli-Renko et al.,
2001b) prefers to focus on companies that are no more than ten years old (yet, for example, De Clerq and
Rangarajan (2008) do not follow this approach). Here, 91% of franchisees joined later than 1996.
the literature (Homburg et al., 2008; McGee et al., 1995; Reinartz et al., 2004; Rust et al., 2002). For sales growth, this study uses a three-year compounded annual rate, as the literature suggests (McGee et al., 1995; West, 2007).

Because this research collects self-reported data from a single source, there are concerns of common method bias. Prior research recommends comparing primary and secondary data to establish validity of survey-based measures (Brush and Vanderwerf, 1992; Chandler and Hanks, 1993; McDougall and Robinson, 1990; Stam and Elfring, 2008; Zahra, 1996a, 1996b, 1996c; Zahra et al., 2002). Corroborating data on past performance for a subsample of 25 firms could be obtained from system sources. Results somewhat alleviate concerns; correlations are 0.97 for first year sales, 0.91 for growth (both \( p < 0.01 \)).

Perceived performance is measured with the previously validated scale used by West (2007; based on Dess and Robinson, 1984; see also, West and Noel, 2009). Although manager personality and aspiration levels could affect perceived performance evaluations, subjective measures have shown strong reliability and validity (Dess and Robinson, 1984; Stam and Elfring, 2008). The scale’s first item assesses the percentage of ideal performance being achieved in the first year after system entry (“ideal” is 100%); its other two items assess initial growth and overall performance in the first year “relative to competitors in the system who are comparable in age” (Abeele and Christiaens, 1986; Dess and Robinson, 1984; Sapienza et al., 1988; West, 2007; West and Noel, 2009). Porter (1980) argues that firms are aware of their competitors’ activities, a position substantiated by Brush and Vanderwerf (1992). In both systems, sales data is shared in the system, so franchisees can assess relative performance. In line with West and Noel (2009) and Stam and Elfring (2008), the items use a seven-point agreement scale (for the latter two items, anchored by the performance descriptors of 1, “much worse,” to 7, “much better”; the first item’s percentages are transformed on a 7-point scale). A composite scale is built by summing and averaging the item scores, using equal weights. Reliability of the scale is assessed by Cronbach’s alpha. The alpha value of 0.96 is well above the lower acceptability limit of 0.60 (Hair et al., 1998). Item-to-total and inter-item correlations confirm construct reliability. When factor analysed, all factor loadings are highly significant, which also indicates convergent validity (Bagozzi et al., 1991; Homburg et al., 2008). A substantially similar scale has been reliably used in other research on new ventures (Lumpkin and Dess, 1995).

**Independent and Control Variables**

**Social Capital Transfer**

This research uses franchisee-reported data as real time data on all customers of all entrepreneurs of both systems prior to and after system entry is not obtainable. To assess social capital transfer and information, this study uses items from previously validated scales, adapted to the study context. As indicators of social capital with customers, retention and loyalty measures are used most often (Chang and Tseng, 2005; Duffy, 2000; Edvinsson and Malone, 1997). Dawkins and Reichheld’s (1990) seminal paper on retention suggests measuring the number of customers staying as a percentage of the original number over a specific period. Duffy (2000) measures customer capital as the number of customers present and the annual sales per customer. Wiesel et al. (2008) propose a model to monitor customer assets by the number of total, new, and lost customers, the cash flow per customer, and the retention rate. Hitt et al. (2006) quantify „relational capital” with clients in law firms by the number of clients, a percentage value of the client’s sales of total sales, and annual compensation received from the client. Following these approaches, franchisees were asked to assess customer capital in the first year after system entry in terms of (1) the number of transferred customers, (2) the percentage of transferred customers of the previous customers (present in the year prior to system entry). (3) the percentage of transferred customers of their franchise outlet customers, and (4) the transferred sales volume. Answers are transformed into categories from 1-5 (1 – low, 5 – high values). A composite scale is built by summing and averaging the four items’ scores, using equal weights. Scale reliability is assessed by Cronbach’s alpha (0.82), item-to-total and inter-item correlations, all of which confirm construct reliability. When factor analysed, all factor
loadings are highly significant, indicating convergent validity (Bagozzi et al., 1991; Homburg et al., 2008).\textsuperscript{8}

\textbf{Information}

Ramani and Kumar (2008) develop a comprehensive model of a firm’s “interaction orientation”. The model reflects a firm’s ability to interact with customers and take advantage of information provided by them. Measures of entrepreneurs’ ability to benefit from customer information used here correspond to items used in their study. Franchisees rate “I encourage my customers to share opinions of my products and/or services with me” and “I encourage my customers to share opinions of my products and/or services with other customers” (see also Macy et al., 2007; Macy and Moore, 2004; Ramani and Kumar, 2008; Sorensen et al., 2008). Gains from interaction are addressed with the items “I use information from my customers, like feedback on products, to improve my business activities”, “My current customer contacts help me attract new customers”; previous studies use related items to assess the impact of customer information on outcomes (De Clercq and Rangarajan, 2008; Dyer, 1997; Ramani and Kumar, 2008; Yli-Renko et al., 2001a).\textsuperscript{9} Franchisees indicate agreement with each item on a 7-point scale (7 – strongly agree, 1 – strongly disagree). The composite scale’s Cronbach’s alpha (0.91), item-to-total and inter-item correlations support reliability.

Franchisees interviewed in the pre-stage all suggested that the approaches taken were appropriate for gathering information on the study context. The study further controls for common method bias in the self-reported variables using Harman’s single factor test. The test yields more than one factor, no factor accounts for most of the variance; thus, following Podsakoff et al. (2003), common method bias should not be an issue.

\textbf{Control Variables}

The study controls for effects of variables that are commonly used in entrepreneurial and franchising research (Baron and Tang, 2009; Cooper et al., 1994; Jambulingam and Nevin, 1999; Low and Abrahamson, 1999; Newbert et al., 2007): franchisee age and education measured in years; gender (1 – male, 0 – female), prior self-employment, prior leadership position and prior industry experience are dummies (1 – yes, 0 – no); franchisee “background” counts family members and friends who were self-employed prior to the franchisee’s system entry. The study includes each franchisee’s year of system entry, so that performance is comparable over time, a system dummy (1 – larger, 0 – smaller system), outlet size (measured by the number of employees, following Yli-Renko and Janakiraman (2008), in categories of 1-3, 4-6, etc.), GDP of the outlet’s area, and the competitive situation in terms of the number of other system outlets in the area, at system entry.\textsuperscript{10}

\textsuperscript{8} The situation is more complex when customers have multiple suppliers or a few customers spend disproportionately. The study does not attempt to specify these issues. Franchisees were confident as regards their ability to observe customer transfer. Measuring transfer based on entrepreneurs’ perceptions follows Roberts and Dowling (2002) who explain that using perceptual measures poses no problem per se (see also Benjamin and Podolny, 1999; Dowling, 2001). One third of sample franchisees could not transfer any customer.

\textsuperscript{9} Survey-based measures of knowledge acquisition have previously been effectively used by Simonin (1997), Yli-Renko et al. (2001a), Zahra et al. (2000) and Zander and Kogut (1995).

\textsuperscript{10} The analysis also controls for non-system competition on a yearly basis, using 2003 to 2006 data; there are no significant results. It further examines if franchisees start their business in the geographical area in which they were active before system entry. Starting a business in the home market correlates with customer transfer (0.48, p < 0.1), but neither with the information variable, nor with sales.
Methods
Cross Sectional Data

Initial investigation reveals that the dependent variables are not normally distributed. Following Chrisman et al. (2002) and Kennedy (1979), this research takes natural logarithms to examine the relationship between social capital transfer and performance (H1a). Following Shane et al. (2006), nonlog variables are used for robustness checks: the regression results do not show substantive differences from the regression with log variables. For testing the implications of customer information on the relationship postulated in H1a, the study estimates moderated OLS regressions (Aiken and West, 1991; Baron and Kenny, 1986). These are appropriate to reveal whether a moderator variable has an influence on the strength and/or form of the relationship between an independent and a dependent variable. Following the methodology by Sharma et al. (1981), to examine interaction effects, information input is treated as a moderator based on the argument that leads up to H1b. The interaction term used in the regressions is the product term of the mean-adjusted scales for social capital transfer and information. The analysis controls for absence of multicollinearity with Variance Inflation Factors (all below three), and for normal distribution of disturbances with Kolmogorov-Smirnov-Tests.

Balanced Panel Data

For testing H2, following Roberts and Dowling (2002), a first-order autoregressive model is used to capture the intertemporal effects of the regressors on sales performance:

\[
\text{PERFORMANCE}_{it} = a_0 + a_1 \times \text{SCTRANSFER}_{it-1} + a_2 \times \text{INFORMATION}_{it-1} + a_3 \times \text{SCTRANSFER}_{it-1} \times \text{INFORMATION}_{it-1} + b_0 \times \text{PERFORMANCE}_{it-1} + e_{it},
\]

Where \(\text{PERFORMANCE}_{it}\) (\(\text{PERFORMANCE}_{it,1}\)) is third (first) year performance of firm \(i\).\(^{11}\)

A fundamental assumption of regression analysis is that the independent variables are uncorrelated with the disturbance term. Otherwise, OLS coefficients can be biased. Here, it is expected that the independent variables that influence first year performance influence third year performance as well, and first year performance is included as a regressor variable. So, potential simultaneity issues arise. The standard approach in cases where a regressor variable is correlated with the residuals is to estimate the equation using instrumental variables regression (Maddala, 2001). As instrumental variables regression, two-stage least squares (2SLS) is employed. Prior industry experience is used as an instrumental variable. The variable fulfils the criteria of relevance and exogeneity (Maddala, 2001) since it influences first year performance (see Models 0-1), and does not influence third year performance directly according to correlations and auxiliary regressions, but only indirectly via first year performance. The logic is that experience provides new franchisees with a know-how advantage at start-up, but that this advantage erodes as other new franchisees acquire the same skills over time. OLS and 2SLS results concur. A Hausman test that indicates that 2SLS results are more reliable. So, 2SLS results are reported. The analysis uses White period estimates as a coefficient covariance method to make sure standard errors are robust to serial correlation (Arellano, 1987; White, 1980).\(^{12}\)

The study compares both systems’ average sample observation with the average outlet-owner computed from each system’s population along the dimensions age, gender, years in business, and prior self-employment. Therefore, it uses previously collected data, and to obtain further information on the populations, officials in the chains were contacted. No evidence of nonresponse biases emerged.

\(^{11}\) Higher initial performance allows investments in additional marketing or customer acquisition and binding activities e.g., which can affect future performance.

\(^{12}\) The two most important controls from Models 0-3 are also included in Model 4 (system dummy and year of entry).
RESULTS

Table 1 displays the coefficient estimates of the OLS and 2SLS Models. Table 2 presents the variables’ statistics and correlations. H1a is supported, social capital transfer enhances performance (Models 1, 2). For sales performance, H1b is supported as well, social capital transfer particularly enhances franchisee performance if customers serve as an important source of information (Model 1). H2 is not supported: although franchisee performance is path-dependent, meaning that higher first year sales correspond to higher later sales (here, in \( t = 3 \)), social capital transfer and interaction effects at start-up do not lead to higher performance in later years (Model 4). In fact, growth rates for franchisees who realise social capital transfer are lower than for other franchisees who do not have that sort of starting advantage (Model 3). Thus, those franchisees who could not transfer social capital will catch up with those who could in later years; after three years, sales performance is about to even out among the two groups. To illustrate this result, in the first year, franchisees who transfer less social capital than the average franchisee have a mean sales disadvantage of 4\% compared with those whose transfer is average or more. After three years, they catch up, reaching 99\% of the other group’s sales performance. Although 4\% seems only a small difference, retail profit margins are traditionally very low in Germany. Often, margins are less than 4\% (Deloitte, 2009). Thus, social capital transfer can strongly influences the franchisee’s ability to generate a positive margin.

Besides, there is a substantial correlation between sales in the first (third) year and a variable indicating whether a franchisee owns multiple outlets today (0.28, \( p < 0.01 \) (0.44, \( p < 0.001 \))). So, initially better performing franchisees tend to have more outlets later.
Table 1: Results

<table>
<thead>
<tr>
<th>Dependent Variable</th>
<th>Model 0</th>
<th>Model 1</th>
<th>Model 2</th>
<th>Model 3</th>
<th>Model 4</th>
</tr>
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<tbody>
<tr>
<td></td>
<td>OLS</td>
<td>OLS</td>
<td>OLS</td>
<td>OLS</td>
<td>2SLS</td>
</tr>
<tr>
<td>C</td>
<td>-82.775** (26.708)</td>
<td>-16.828 (17.104)</td>
<td>-100.278 (61.064)</td>
<td>-14.351 (8.757)</td>
<td>-43.416** (13.166)</td>
</tr>
<tr>
<td>Social Capital Transfer</td>
<td>0.155*** (0.032)</td>
<td>0.259** (0.088)</td>
<td>-0.036** (0.013)</td>
<td>0.012 (0.045)</td>
<td></td>
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<tr>
<td>Information</td>
<td>0.156*** (0.029)</td>
<td>0.389*** (0.092)</td>
<td>-0.06** (0.013)</td>
<td>-0.051 (0.042)</td>
<td></td>
</tr>
<tr>
<td>Social Capital Transfer x Information</td>
<td>0.038* (0.016)</td>
<td>0.048 (0.006)</td>
<td>-0.018* (0.008)</td>
<td>-0.016 (0.015)</td>
<td></td>
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<tr>
<td>Sales Performance, t=1</td>
<td>0.486† (0.252)</td>
<td></td>
<td></td>
<td></td>
<td></td>
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<tr>
<td>Age</td>
<td>0.002 (0.005)</td>
<td>0.002 (0.003)</td>
<td>-0.014 (0.012)</td>
<td>-0.003 (0.002)</td>
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<tr>
<td>Gender</td>
<td>0.103 (0.085)</td>
<td>0.008 (0.059)</td>
<td>0.167 (0.189)</td>
<td>-0.036 (0.027)</td>
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<tr>
<td>Education</td>
<td>-0.016 (0.012)</td>
<td>-0.007 (0.007)</td>
<td>-0.042 (0.026)</td>
<td>0.002 (0.004)</td>
<td></td>
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<tr>
<td>Self-Employment</td>
<td>-0.182** (0.069)</td>
<td>-0.039 (0.046)</td>
<td>0.016 (0.159)</td>
<td>0.044† (0.023)</td>
<td></td>
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<tr>
<td>Leadership</td>
<td>0.251*** (0.070)</td>
<td>-0.035 (0.051)</td>
<td>-0.012 (0.172)</td>
<td>0.017 (0.025)</td>
<td></td>
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<tr>
<td>Industry Experience</td>
<td>0.304*** (0.070)</td>
<td>0.110* (0.042)</td>
<td>0.081 (0.164)</td>
<td>-0.021 (0.024)</td>
<td></td>
</tr>
<tr>
<td>Background</td>
<td>0.021 (0.021)</td>
<td>0.007 (0.014)</td>
<td>-0.051 (0.046)</td>
<td>-0.008 (0.007)</td>
<td></td>
</tr>
<tr>
<td>Competition</td>
<td>-0.001 (0.016)</td>
<td>-0.000 (0.010)</td>
<td>-0.006 (0.036)</td>
<td>-0.000 (0.005)</td>
<td></td>
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<tr>
<td>GDP</td>
<td>-0.051 (0.070)</td>
<td>-0.066 (0.048)</td>
<td>0.082 (0.169)</td>
<td>0.022 (0.023)</td>
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<tr>
<td>Year (System Entry)</td>
<td>0.047*** (0.013)</td>
<td>0.014* (0.009)</td>
<td>0.053† (0.030)</td>
<td>0.007† (0.005)</td>
<td>0.022** (0.007)</td>
</tr>
<tr>
<td>Outlet Size</td>
<td>0.149* (0.065)</td>
<td>0.086* (0.039)</td>
<td>0.142 (0.145)</td>
<td>-0.018 (0.021)</td>
<td></td>
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<tr>
<td>System</td>
<td>0.555*** (0.142)</td>
<td>0.688*** (0.094)</td>
<td>0.999*** (0.321)</td>
<td>-0.090† (0.046)</td>
<td>0.212 (0.194)</td>
</tr>
<tr>
<td>F</td>
<td>7.312***</td>
<td>27.613***</td>
<td>10.428***</td>
<td>10.296***</td>
<td>24.402***</td>
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<tr>
<td>R²</td>
<td>0.379</td>
<td>0.746</td>
<td>0.526</td>
<td>0.523</td>
<td>0.580</td>
</tr>
<tr>
<td>Adj. R²</td>
<td>0.327</td>
<td>0.719</td>
<td>0.476</td>
<td>0.472</td>
<td>0.563</td>
</tr>
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Significance levels (two-tailed): *** p < 0.001; ** p < 0.01; * p < 0.05; † p < 0.1
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<tr>
<td>(18) System</td>
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Significance levels (two-tailed): *** p < 0.001; ** p < 0.01; * p < 0.05; † p < 0.1
LIMITATIONS AND DISCUSSION

Research Limitations

There are some limitations to the study that also provide avenues for future research. First, because real-time measures are unavailable, the analysis relies on self-reported survey data. To guard against the issues related to such data, the study checks for common method bias, verifies self-reported data with previously collected data and system data, and uses previously validated scales when possible. Further research could examine social capital transfer from the customer’s perspective. Another limitation is survivor bias that is a common restriction to economic research.

Discussion

Based on the premise that entrepreneurs differ in their potential for wealth creation and that chains benefit if franchisors are more able to select potentially better performing franchisees from the pool of applicants, this research addresses the question of what makes a good franchisee. As the performance effects of many entrepreneurial characteristics, like demographic or personality characteristics, are context-dependent, the study focuses on entrepreneurs’ social capital with customers. The literature explains that social capital with customers is most central to profit generation, thus will affect performance across multiple contexts. The thinking is that entrepreneurs can use customer relationships that they have established in another occupation, prior to system entry, as an asset for starting as a franchisee. Transferring customers from a previous occupation into the franchise arrangement provides advantages like “certain” sales and referrals.

The study tests the impact of social capital transfer using panel data from 175 franchise outlets. The franchise context is particularly useful for testing this impact as (nearly) “all other things are equal”, meaning that the conditions under which a system’s entrepreneurs start are much more homogeneous – regarding the business concept, product portfolio, initial investments, franchisor support etc. – than those for independent entrepreneurs. The empirical results show that social capital transfer enhances initial performance and thus offers a starting advantage. Social capital transfer increases sales particularly if customers serve as a source of information for the entrepreneur and for other consumers. First, the entrepreneur learns to better adjust to customers’ expectations, and second, spreading word-of-mouth about the entrepreneur’s good service brings in new customers. Yet, benefits of social capital transfer seize over time: franchisees who perform better at start-up still tend to perform (a little) better than others later on, but social capital transfer and interaction effects at start-up themselves do not lead to higher performance in later years. Growth rates for franchisees who realise social capital transfer are lower than for other franchisees who do not have that sort of starting advantage. At the end of the third year, 75% of first year performance differences among customer-transferring and non-transferring franchisees have evened out. Thus, social capital transfer offers a strong short-term, but not a strong lasting, advantage. Following these results, although entrepreneurs realise gains in the beginning, bandwagon effects of comparably high initial demand are rather small.

The fact that performance evens out over time may be attributed to outlet capacity or customer lifecycle arguments. First, most likely, there is a maximum capacity to serve customers for every outlet, for instance, because of technical reasons or the franchisor’s territorial strategy. The degree of initial capacity used is higher for customer-transferring franchisees, while the others have to acquire customers over time. Successively, the others catch up, until they reach a similarly strong capacity utilisation. Second, customer relationships exhibit lifecycle features, so transferred customers will not patronize an outlet for ever. Over time, they will stop, for example, because they come to prefer another seller or stop buying the product category. The literature on customer switching behaviour yields numerous reasons for churn behaviour (Keaveney, 1995; Reichheld, 1996), like service failure, pricing, competition, inconvenience (like waiting times), even in cases where customers are basically satisfied.
If customers stop patronizing, they are likely to also stop making referrals to other consumers. So, transferred customers become less important as a source of information over time; there are no referral “cascades” that make customer transfer a strong lasting advantage. In addition, the value of customer information for franchisees may decline because know-how accumulation shows decreasing returns to scale (Tikoo, 2002). Successively, the franchisee learns about the system’s product portfolio and the new customers, so additional input is less valuable later on than at start-up. Successful franchisees’ motivation to acquire and adjust to information may further decrease over time – as Shepherd and DeTienne (2005, p. 104) explain, “prior knowledge leads to the identification of more opportunities [...], but over time and with tenure in a particular firm some individuals may allow themselves to become entrenched in mental ruts”.

This study provides a diagnostic framework for entrepreneurs and franchisors to evaluate performance prospects based on social capital with customers. The study results have implications for both. First, entrepreneurs must create and exploit opportunities for building customer capital, and understand customer relationships as learning opportunities. Individuals who plan to join a system can intensify customer-binding activities before system entry to enhance career perspectives.

A premise in much of the network literature is that the higher the number of external relationships, the more benefits the firm can realise (Gulati et al., 2000). Some studies examine if there is an upper limit to this argument, and emphasise the importance of focusing on a limited number of high-value relationships because of transaction costs and managerial effort required for maintaining and utilizing relationships (Lettl et al., 2006; Yli-Renko and Janakiraman, 2008). As the relationship marketing literature points out, small sellers will find it challenging to engage in relationships with all customers and thus, must selectively allocate their attention across external activities (including spending time with customers) and internal activities (Cooper et al., 1997; De Clerq and Rangarajan, 2008). Here, there is not an upper limit regarding franchisees’ customer relationships: the more, the merrier. Yet, possibly, inverted effects do not occur since obtaining information does not necessitate extensive managerial efforts or, again, due to capacity arguments – as franchisors exert territorial control, outlets never come to interact with “infinite” numbers of customers, but serve a certain number and if more customers come, another outlet will open proximately.

Good news for franchisees who cannot transfer customers is that at last, they will catch up with those who can. Good news for those who can transfer customers is that because initially successful franchisees tend to have more outlets later, good initial performance still pays off in later years, if not in the initial outlet, by being allowed to open more outlets over time.

Second, franchisors must consider that they do not only choose the franchisee, but they may also choose an integral part of their new customer base when accepting a franchisee into the system. As customer-transferring franchisees provide higher sales and thus higher profits to the system centre for several years after start-up, franchisee screening and selection should be responsive to franchisee’s abilities to transfer customer capital. Customer-transferring franchisees may further cause less costs for initial support. Possibly, it pays off to provide them with a broader initial product portfolio than the average new franchisee, or to let their outlets test innovative products, because they may receive more valuable feedback from customers and may be more able to promote product diffusion in the market than less successful system members. Because of higher revenues, these franchisees can also pay back entry fees faster, so offering better financial conditions to attract them into the particular system could be an option. As Burt (1992, p. 6) observes, “To the extent that people play an active role in shaping their relationships, then a player who knows how to structure a network to provide high opportunities knows whom to include in the network”. Gibb and Davies (1990, p. 16) argue that “it is perhaps an unrealistic expectation that it will be possible definitely to pick winners or indeed to produce a comprehensive theory that leads to this. But arguably it is better to make further strides towards better understanding of the
factors that influence the growth process”. Additionally, results indicate that consumers do not necessarily choose the brand before patronizing a specific outlet as widely believed (Dant (2008) points this issue out as an important research question), but loyalties can rather be based on the entrepreneur, who makes consumers choose the brand.

Proposing that economic explanations for entrepreneurial success are incomplete and undersocialized, this study contributes to the field by showing that social capital transfer is an important mechanism that affects entrepreneurial success. So, there is general support for the premise of this research.
REFERENCES


St-Onge HS. Tacit knowledge: the key to the strategic alignment of intellectual capital. Strategic & Leadersh 1996; 24: 10–14.


CORRELATES OF SUCCESSFUL FRANCHISE PERFORMANCE

Hyo Jin (Jean) Jeon and Rajiv P. Dant, University of Oklahoma
Brent L. Baker, University of North Dakota

ABSTRACT
Surprisingly despite the large footprint of franchising in the retailing arena, not much is known about the primary drivers of performance in franchising systems. With some notable exceptions, much of the franchising literature on performance related issues has focused on either contrasting failure rates of independent small businesses and entrepreneurs with those of franchises and/or system survival issues. In addition, in the existing literature on franchising performance, most studies have restricted themselves to a single sector, usually, the fast food restaurant industry, since it is often perceived and portrayed as the archetypical franchise sector. In this study, we attempt a systematic assessment of the relative effects of a series of firm decision variables on performance drawing on the theoretical framework of organizational learning as manifested within the resource based view of franchising. We test a total of eleven hypotheses utilizing data from 506 franchise systems taken from the Bond’s Franchise Guide 2008 (Bond 2008). These systems tap all the franchising sectors in the economy. Results from this study provide empirical support for seven of our hypotheses. Franchisors’ strategic plans on certain decision variables (i.e., advertising fee, experience of the franchisor, new projected units, provision of sub-franchising, total initial training, assistances provided to the franchisees, and geographic dispersion) emerge as the primary drivers of the successful franchise systems. We close with a discussion of implications for future research and managerial action.

INTRODUCTION
Franchising is one of the most popular business forms for retailers and services providers. Dyadic relational parties, a franchisor and a franchisee, agree upon the usage of tangible and intangible resources and share values and goals of a franchise system. Franchisors provide brand equity and the proven business format to franchisees during the contracted periods. Franchisees compensate for their use of the franchising brand and business format through payment of the initial franchisee fee and ongoing service fees. Some examples of ongoing service fees include advertising fees for the contracted period and annual royalties based on sales (Shane 1996). Small and young firms that desire fast growth employ franchising to obtain financial, managerial, and local market knowledge resources for rapid expansion from their franchisee partners (Oxenfeldt and Kelly 1969). Norton (1988) pointed out that franchising allows the firms to overcome managerial limits since the franchisees are residual claimants on the profits of the franchised units. The problems, costs, and responsibilities related to selecting, assimilating, and monitoring employees are transferred to the franchisees. On the other hand, franchisees are often convinced of joining franchise systems because of the proven business format and ongoing operational support from franchisors which are perceived as guarantors of financial success and a shield from operational obstacles that often contribute to the failures of independent start-up businesses. The economies of scale of the franchise systems help franchisees to buy raw materials and supplies at a lower rate through franchisor negotiated rates. Additionally, brand name reputation helps franchisees to survive in the competitive market.

Within the franchising context many researchers have actively discussed the issue of failures in the franchise system based on franchisors’ operational characteristics. For example, Lafontaine and Shaw (1998) studied the five year survival rates of franchising systems in the U.S. using data from various publicly available sources such as Franchising in the Economy, The Franchise Annual, Bond’s Franchise Guide, and Entrepreneur magazine. They concluded that a franchisor’s chances of remaining in franchising for 5 years or more are influenced by the franchisor’s business experience prior to franchising. Holmberg and Morgan (2003) attempted to identify the predictors of franchise turnover and failure based
on the Uniform Franchise Offering Circular (UFOC) registration data by broadening the franchisee failure perspective. They proposed the Holmberg-Morgan franchise failure continuum model where absolute failure and success were merely the end points of the continuum. Some researchers were able to show the relationship between the failure of small entrepreneurs and franchise systems’ operational characteristics (Michael and Combs 2008; Shane 1998). For example, franchise failure is negatively related to requiring previous industry experience and active ownership from their franchisee partners. Meanwhile, empirical studies on entrepreneurs’ failures in franchise systems have encouraged many researchers into questioning why certain franchisors and franchising systems perform better than the others. This has led to investigations examining the successful operational strategies of franchisors.

Within the franchise context, previous literature has focused on how a firm could be successful by employing outside resources into the firm. Resource constraints theory identifies capital and labor from franchisees that can accelerate the growth of firms. The small and young firms intend to gainfully employ financial, managerial, and local market knowledge resources from franchisees to grow faster. Additionally, the large chains have advantages of economies of scale, and firms are willing to increase the size of franchise systems to gain economic benefits. Resource constraints theory argues that the franchisor will repurchase back the operating units from existing franchisees when the franchisor is no longer constrained by resources (Oxenfeldt and Kelly 1969). Under the agency theory perspective, the firms can reduce monitoring cost by having franchisees as distribution system members that deliver products and services to consumers. Outcome-based contracts between a franchisor and a franchisee allow the franchisee to align its goals with the franchisor. However, previous studies lack explanation and evaluation on franchisors’ capabilities to integrate different resources from diverse chain members. How franchisors transfer the accumulated resources from headquarters to local operating units has not been investigated as competitive advantages of the successful franchise systems. In addition, the relationship among franchisors’ capabilities to balance the different interests of chain members, strategy, and performance should be explored as factors to become a successful organization. For instance, Dant and Gundlach (1999) found that some franchisors manage conflict better than others. Some franchisors have better capabilities to balance diverse interests of chain members than the others.

In this study, we argue that franchise systems that develop and recognizing organizational learning as their source of sustainable competitive advantage are likely to be successful. The successful franchise systems have competitive advantages to efficiently acquire external and internal resources from diverse chain members, to distribute the integrated knowledge and resources, and to exchange feedback on the transferred knowledge and resources. Our objective is to examine what strategies related to structure, service, and geography drive some franchisors to be more capable of actively engaging in this process of organizational learning. Even though several researchers (e.g., Bradach 1997; Sorensen and Sorensen 2001) have discussed how a hybrid governance structure (i.e., franchise systems) can be involved in learning organization activities, the merits of franchisors’ strategies that propel the process of organizational learning has not been discussed in the literature. First, we develop the overarching theory of the governance, organizational learning, and strategy to explain the unique nature of franchise systems. Later, to extend our understanding of how franchisors’ strategies affect franchise systems in the process

13 Holmberg and Morgan (2007, page 385) argued that “the fundamental issue is not to correctly define franchise failure and place all franchisees into either a ‘success’ box or a ‘failure’ box, but to more appropriately broaden the focus to develop a franchise failure continuum as a conceptual foundation for the analysis of ‘failure’ and associated data analysis.” They believed that franchisee failure is not a single event but a continuum with multiple stages. Holmberg-Morgan strategic management franchise failure continuum model suggests the following eight stages including: (1) franchisee competency and expectation fit, (2) franchisee-franchisor satisfaction/dissatisfaction, (3) franchisee discontent, (4) royalty delinquency, (5) Complaints, (6) turnover/transfer termination, (7) default/other losses to creditors, and (8) closure.
of organizational learning, we borrow on two related theoretical perspectives of resource constraints theory and resource based view, to develop our specific hypotheses. Resource constraints theory is one of the most commonly employed perspectives to understand why a firm franchises (Carney and Gedajlovic 1991; Castrogiovanni, Combs, and Justis 2006; Lafontaine and Kaufmann 1994). Combs and Ketchen (2003) have suggested that resource-based view can permit franchising researchers to gain a richer understanding of franchise performance. Thus, resource-based view is adopted to explain the relationship between strategic resources and capabilities of successful franchisors and franchise performance. The relevant literature related to resource constraints theory and resource based view is reviewed to establish how the franchise systems can be successful by adequately bringing scarce knowledge resources and their learning capability into the franchise systems and by developing the capability to integrate and to transfer such knowledge resources. A summary of literature related to franchise performance is presented in Table 1.
<table>
<thead>
<tr>
<th>Articles</th>
<th>Setting</th>
<th>Theoretical Framework</th>
<th>Focal Variables</th>
<th>Key Findings</th>
</tr>
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<tbody>
<tr>
<td>Lafontaine &amp; Shaw (1998)</td>
<td>Empirical; 130 franchisors from various industries; Various sources; Logit regression</td>
<td>Life-Cycle theory</td>
<td>Prior business experience; Royalty rate; Advertising rate; Franchise fee; Capital required; Outlets when began franchising; Order of appearance in survey; Seeking in U.S., Canada, &amp; overseas</td>
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|                  |                                                                         |                       | Five year survival                                                              | No significant sectoral differences in success probabilities were found.  
|                  |                                                                         |                       |                                                                                | They concluded that most of publicly available initial observables on franchising companies have little capacity to explain future success or failure.  |
| Shane (1998)     | Empirical; 157 franchisors from various industries; Sourcebook of Franchise Opportunities over the period 1981-1985; Cox regression | Agency theory         | Passive ownership; Cash investment; Franchisee experience; Royalty rate; Complexity; Master franchise agreements; Contract length; Total investment | Exit from franchising system; Age; Size  
|                  |                                                                         |                       |                                                                                | [H1] New franchise systems which permit passive ownership of franchised outlets are more likely to fail than are other new franchise systems.  
|                  |                                                                         |                       |                                                                                | [H2] New franchise systems which require higher levels of franchisee cash involvement are less likely to fail than are other new franchise systems.  
|                  |                                                                         |                       |                                                                                | [H3] New franchise systems which require franchisees to have experience are less likely to fail than are other new franchise systems.  
<p>|                  |                                                                         |                       |                                                                                | [H5] New franchise systems which are geographically concentrated are less likely to fail than are other new franchise systems.  |</p>
<table>
<thead>
<tr>
<th>Study</th>
<th>Methodology</th>
<th>Variables</th>
<th>Theory</th>
<th>Findings</th>
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<td>Jambulingam &amp; Nevin (1999)</td>
<td>Empirical; 632 franchisees from various industries; Fran data mailing list; regressions</td>
<td>Investment; Prior experience; Prior self-employment; Own other businesses; Manage operations; Age; Gender; Education; Ethnicity; Marital status; Perceived innovativeness; Desire development; Seek challenges; Commitment; Risk taking</td>
<td>Agency theory</td>
<td>Perceived cooperation; Franchisee’s satisfaction with the business decision; Franchisee’s opportunistic behavior</td>
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<td>Michael (2000)</td>
<td>Empirical; 99 restaurant franchisors; Univorm</td>
<td>Franchised units; Owned units; Training weeks; Experience</td>
<td>Transaction cost economics; Bargaining</td>
<td>Litigation</td>
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- [H6] New franchise systems which are more complex are more likely to fail than are other new franchise systems.
- [H7] New franchise systems which employ master franchising are more likely to fail than are other new franchise systems.
| Franchise Offering Circular (UFOC); negative binominal regression & OLS regression | power | requirement; Percent tied; Exclusive territory granted; Years franchising; Three year growth rate | program rises, litigation falls, all other things equal.  
• [H3] Systems that require previous industry experience of their franchisees will experience higher litigation, all other things equal.  
• [H4] Systems that require franchisees to buy a higher proportion of inputs from the franchisor will experience higher litigation, all other things equal.  
• [H5] Systems that grant franchisees an exclusive territory will experience lower litigation, all other things equal. |
|---|---|---|---|
| Alon (2001) | Empirical; 361 franchisors from various industries; Entrepreneur magazine; OLS regression | Resource scarcity theory; Agency theory | Total number of units; Years since firm began; Yearly growth rate; Geographical scope of operation; Average start-up costs; Average royalty rates | Proportion of franchised outlets | The proportion of franchising used by retailers is positively related to size and geographical scope, and negatively related to the rate of growth and the level of investment.  
• [H1] Holding the current proportion of franchised outlets constant, franchisor size is negatively related to the subsequent proportion of franchised outlets.  
• [H3] multinational scope is positively |
<p>| Castrogiovanni Combs &amp; Justis (2006) | Empirical; 439 franchisors from various industries; Entrepreneur magazine; Hierarchical | Resource scarcity theory; Agency theory | Franchisor size; Years franchising; Multinational scope; Start-up costs | Proportion of franchise outlets | Prior proportion of franchise outlets; Industry; Ongoing sales royalty; Up-front |</p>
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<td>Royalty rate is positively related to franchise system growth.</td>
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- [H1] The duration of franchise contracts will increase with the franchisee’s initial investment requirement.
- [H2] will increase the required amount of offsite training.
- [H3] will increase as the franchisor gains experience in franchising.
- [H5] will be longer for firms with a high concentration of units in states with laws that restrict the franchisor’s right not to renew franchise contracts.
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| Hossain & Wang (2008)  | Empirical; Bond’s Franchise Guide 2006; Partial least square | Life-Cycle theory; Resource scarcity theory | - [H1] A franchisor’s cumulative franchising experience will be negatively correlated with the site location assistance offered by the franchisor.  
- [H2] will positively impact the length of start-up training required by the franchisor.  
- [H3] will positively impact the duration of franchising contacts.  
- [H4] As a franchisor’s cumulative franchise system growth.  
- [H6] The number of franchisor growth initiatives is positively related to franchise system growth.  
- [H8] The extent of rigor used by the franchisor to select new franchisees is positively related to franchise system growth.  
- [H9] The extent of ongoing services provided by the franchisor to all franchisees is positively related to franchise system growth.  
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Experience increases it will charge lower royalty and franchise fees.

- [H5] its propensity to expand its system size will be declining.

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|                        | **[H1]** Franchisee failure is negatively related to requiring industry experience.  
 |                        | **[H2]** is negatively related to requiring active ownership.  
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 |                        | **[H4]** is negatively related to exclusive territories.  
 |                        | **[H5]** is negatively related to investments in brand name.  
 |                        | **[H6]** is negatively related to the length of training.  |
THEORY AND HYPOTHESES

Governance, Organizational Learning, and Strategy

Franchise systems are often used as an example of hybrid organizational forms that include aspects of both markets and hierarchies (Williamson 1991). Franchise systems can be considered as a market-based firm because an organization recruits an entrepreneur to operate a local unit bounded by a contract. However, many franchise systems attempt to maintain a certain proportion of company-owned units for a variety of strategic advantages stemming from the de facto plural forms (Bradach 1997; Dant and Kaufmann 2003). Therefore, governance structure in franchise systems is neither comprehensively integrated firms (ownership) nor comprehensively market-based firms (franchising) (Carney and Gedaklovic 1991).

The hybrid organizational form in franchise systems requires franchisors to constantly engage in various interactions with individuals (e.g., employees in the headquarters, managers of the company-owned units, and franchisees) who may share the overarching goals of the system but simultaneously have different vested interests. As this wealth of interaction based knowledge and experiential learning accumulates, franchisors have to develop capabilities to convert these different pieces of information into new knowledge and resources that can influence behaviors of the chain members to improve the overall performance of the franchise systems (Fiol and Lyles 1985; Sinkula 1994; Slater and Narver 1995). The process of organizational learning evolves the steps of information acquisition, distribution, interpretation, and memory (Huber 1991; Sinkula 1994). Within the context of franchising, franchise systems would acquire knowledge from direct experience in company-owned units, the experiences of franchisees, and organizational memory in headquarters (Slater and Narver 1995). Walker and Weber (1984) argue that the franchisors can obtain direct knowledge of operational details and business difficulties through company-owned units. In contrast, Oxenfeldt and Kelly (1969) believe that the franchise systems gain the managerial and local market experiences by working with franchisees.

In the stage of knowledge acquisition, organizations must balance their learning between exploitation and exploration (March 1991). Exploration comprises such organizational activities as risk taking, experimentation, discovery, and innovation. Exploitation in organizational learning involves activities that are characterized as refinement, efficiency, implementation, and execution. Because organizations that are only focused on exploitation may not see the opportunities the untapped knowledge and resources can generate, organizations need to engage in exploratory learning as well. In addition, organizations incrementally improve operational efficiencies through exploitation. For instance, Sorensen and Sorensen (2001) state that the governance structures influence the process of organizational learning and franchise systems gain advantages by balancing the exploitation from company-owned units and the exploration from franchised units. Moreover, acquired information is integrated by the franchisor, and the integrated knowledge is distributed to chain members (Sinkula 1994). Finally, through the process of information interpretation all chain members freely exchange feedback and modify the given knowledge and resources (Sinkula 1994). This cyclical process of organizational learning can be repeated, and new insights are stored and used in the future.

The foundations of sustained competitive advantage are equipped when an organization possesses capabilities or resources that are valuable, rare, imitable, and substitutable (Barney 1991). The exclusively developed processes of organizational learning are resources of the franchise systems and become sustainable competitive advantages of organizations to survive in the competitive market environment (Slater and Narver 1995). If a particular franchise system can process organizational learning more effectively in lesser time than its competitors, then the organizational culture and the capabilities within this focal franchise system can be considered as a source of sustained competitive advantage. For example, one of the key hallmarks of franchise systems is the standardization and uniformity of their products and services throughout their entire networks of operating units. Hence, normatively, all individuals in franchise systems should be actively engaged in organizational learning since franchisors’
knowledge and experiential resources need to be transferred from the headquarters to managers and franchisees. The franchise systems often test the performance of new products and procedures in company-owned units so the franchisors can persuade franchisees to adapt to the innovation (Bradach 1998). These constant procedures of organizational learning through the company-owned units enable franchisors to gain and to maintain their expert power over their franchisees (Dant and Kaufmann 2003; French and Raven 1959). However, this learning is bidirectional in that franchisors acquire and adapt to local market conditions through the feedback from their franchisees (Oxenfeldt and Kelly 1969). This may be especially salient for systems operating in overseas markets because market variability in foreign countries is likely to be greater and the ultimate success of these overseas operations may be dependent on synergy arising from local market information related to the foreign market environment from franchisees with the franchisor’s know-how (i.e., the proven business format, the product mix, and the brand name reputation) (Alon and McKee 1999).

In order to facilitate the process of organizational learning as sustainable competitive advantage within franchise systems, the participations of franchisees in the process are critical. Franchisees acquire new knowledge from their own experiences and from franchisors. After franchisors distribute the integrated and previously interpreted knowledge to all extant chain members, franchisees can engage in interpretation of knowledge and resources by exchanging feedback on the implication of such knowledge in local units. The unique organizational structure of franchise systems compel and require both franchisors and franchisees to constantly learn from one another (Sorenson and Sorensen 2001). In other words, organizational learning is embedded into the franchise system since the nature of relationship between franchisor and franchisee requires them to simultaneously acquire, distribute, and interpret knowledge and resources. Hence, this process of organizational learning in franchise systems becomes a critical strategic resource and a powerful predictor of the success of franchise systems. In conclusion, organizational learning determines the organization’s ability to survive (Fiol and Lyles 1985). Therefore, the strategies of franchise systems should be designed to strengthen the process of organizational learning.

**Resource Constraints Theory and Resource Based View**

Oxenfeldt and Kelly (1969) suggested that emergent growth-oriented firms use franchising to efficiently acquire scarce resources that franchisees own. The small entrepreneurs in their early stage of the development of the firms face constraints in the resources such as financial resources, managerial resources, and regional information (Dant and Kaufmann 2003). When the firms face the limitation to attain the desired growth rate using the internally available resources in the competitive market environments, such firms opt for the economies of scale access to these resources through franchising (Oxenfeldt and Kelly 1969). It might be difficult for such entrepreneurs to raise capital through the financial markets (i.e. public stock offering and issuing corporate bonds) and expensive for them to obtain loan capital from financial institutions. Gilman (1990) believed that financial resources are crucial for franchisors to run marketing strategy for the survival and expansion of the franchise system. Franchisees are obligated to pay the lump-sum amount of initial franchisee fee and the ongoing royalty fees (usually expressed as a percent of the sales) to their franchisors. The franchising contract is crafted so that there is no lawful obligation for the franchisor to reimburse the franchisees for their initial franchise fees upon the termination of their relationship. Financial resources taken from franchisees in this manner also free the franchisor from potential intervention of investors (stockholders) that may directly influence the managerial decision of the public corporation.

Based on the arguments of resource constraints theory, franchisors were theoretically predicted to reacquire their franchised units as size of the franchise firm and hence the availability of financial resources grew (Oxenfeldt and Kelly 1969). This dark prophecy became enshrined in the franchising literature at the ownership redirection thesis (Baker and Dant 2008; Dant and Kaufmann 2003). However, several scholars have discovered that most franchisors do not have an interest in reacquiring the
ownership of their entire franchise systems, but that they prefer to maintain a particular targeted proportion of franchised units (Lafontaine 1992; Lafontaine and Kaufmann 1994), presumably to take strategic advantages of tapered integration implicit in stable plural distribution (Dant and Kaufmann 2003). So long as a franchisor has developed some unique proficiencies to successfully deliver standardized products and services through its franchised units, such a franchisor is likely to recognize this capability as a resource and a source of competitive advantage of the firm.

Any tangible and intangible assets that are tied semi-permanently to the firm can be defined as a firm’s resources (Wernerfelt 1984). All assets, capabilities, organizational processes, firm attributes, information, and knowledge can be considered as “strategic resources” if they create value to achieve an advantage over competitors (Barney 1991; Wernerfelt 1984). Strategic resources have characteristics to be valuable, rare, in-imitable, and non-substitutable (Barney 1991; Porter 1980). Therefore, resources in franchise systems are not limited to the exchanged resources like brand name or resources that are contributed by franchisees (i.e., financial, managerial, and informational resources). The franchisors’ knowhow to integrate diverse resources from chain members and to craft efficient procedures to convey in-house knowledge to local units are also resources of franchise systems.

In our study, we identify three subsets of strategies (i.e., structure, service, and geography) that learning franchise organizations can employ as potential drivers of successful franchise systems. Strategies of structure refer to stable practices and characteristics of the focal franchise systems (e.g., provision of sub-franchising, fee structures, growth plans, etc.) that are hypothesized to lead systemic success. Strategies of service allude to the provision of various ongoing or initial services extended by the focal franchise systems to their franchisees (e.g., financial, site-selection, lease negotiation assistances at the inception of the franchise partnership, and a host of ongoing assistances, etc.) to create differential advantage for their systems. Finally, strategies of geography pertain to system dispersion strategies of the focal franchise systems in terms of number of states and provinces they operate in as well as their prospective expansion plans, since rapid geographic dispersion has been cited as a key strategic advantage of growth through franchising as opposed to growth as wholly-owned corporate systems. Together, these three strategy categories comprise the slate of the eleven hypotheses that we empirically examine in this investigation.

**Hypotheses Related to Strategies of Structure**

Operationally, we specify and investigate five hypotheses related to strategies of structure: (1) Initial Franchise Fee (H1), Ongoing Advertising Fee (H2), Cumulative Franchisor Experience with the system since the initial franchise sale (H3), Projected Count of New Units expected to be opened in the following year (H4), and the Provision of Sub-Franchising (H5).

Hossain and Wang (2008) have argued that older and larger franchise systems are reluctant to offer exclusive territories to franchisees while young franchisors offer more attractive territories by asking for higher franchisee fees. However, franchisors that have established market power have the ability to charge higher franchisee fees since such initial franchisee fees compensate the franchisor for the use of its brand name reputation and its developed business format based on its cumulative experience (Ingram 1996; Love 1986; Luxenberg 1985). Therefore:

**H1:** Success of the franchisor is positively related to the amount of the initial franchisee fee charged by the franchisor.

Franchisees are required to pay ongoing fees (i.e., advertising fees and royalty), as a designated proportion of their sales. The economies of scale in advertising allow the firm to compete effectively in the competitive market (Combs and Castrogiovanni 1994). The ongoing financial contribution of franchisees is not only the direct source of revenue of the franchisor but also allows the franchisor to carry
out national advertising to increase brand awareness of the franchise system (Michael 1999). The brand name reputations are vital for the success of franchise systems. Because the franchisor’s brand name signals coherent quality to potential customers (Norton 1988; Klein 1995) argued that brand name reputations create pricing power in the market and brand name reputations would increase the overall sales in the franchise system especially since first-time purchases of customers are mostly based on brand name reputation (Luxenberg 1985; Shook and Shook 1993). Additionally, the attractiveness of the potential franchisees toward the system would increase as well when the market power of the franchise system is greater than its competitors. Therefore, aggressive national advertising is crucial for the franchise system to bring more scarce resources into the franchise system and to grow faster. This leads to:

**H2:** Success of the franchisor is positively related to the rate of advertisement fees.

Organizational learning is fundamental to the nature of franchise systems, and the degree of organizational learning in franchise systems likely determines their survival in the competitive market. The governance structure forces the franchise systems to develop the unique ways to acquire market information from both the company-owned units and franchisee-owned units. Moreover, as noted earlier, franchise systems distribute the aggregated information into the managers and the franchisees (Sinkula 1994). Bradach (1997) emphasized the value of learning in franchise systems, and Sorenson and Sorensen (2001) agreed and supported Bradach’s findings based on large-scale empirical evidence. Total knowledge and capabilities of franchisors are acquired from franchisors’ cumulative franchising experiences, and those experiences drive the growth of the franchise systems (Hossain and Wang 2008). Firms learn to persuade franchisees to align their goals with the franchise systems, to adopt new resources from diverse franchisees, and to balance the relationship among chain members. Thus, the franchising experience of franchisors would have a positive influence on the success of the franchise system.

**H3:** Success of the franchisor is positively related to the experience of the franchisor with its franchising system.

Decisions to strategize firms’ growth rates are closely related to the survivals of firms. Since the capabilities of franchisors as supervisors managing and monitoring franchise systems are determined by growth rates, the projected growth rate is an important predictor of franchise systems’ success. Carney and Gedajlovic (1991) found that the desired growth rate varies by franchisors. They clustered franchise systems into five sub-groups (i.e., rapid growers, expensive conservatives, converters, mature franchisors, and unsuccessful) based on their projected growth strategies. Rapid growers tended to expand using franchising since franchisors can quickly reach to the feasible and desirable levels of efficiency and overcome resource scarcity; in contrast, the mature franchisors rely less on franchising and use franchising to reduce monitoring costs. Even though many organizations franchise to facilitate growth, some tend to put greater effort towards aggressively expanding. In the longitudinal growth patterns’ study, Castrogiovanni and Justis (2002) demonstrate the significantly positive relationship between the growth orientations of franchise systems and firm growth. Because the franchisors’ orientations on the system growth are positively related to the actual growth of the system, some franchisors that want to expand faster would plan for aggressive expansion of new units. If franchisors have developed capabilities to integrate and to transfer the accumulated knowledge and resources into the new units, then the expansion plan would drive the success of the franchisors.

**H4:** Success of the franchisor is positively related to its expansion plan.

A master franchise is a form of “umbrella” licensing agreement (Kaufmann and Kim 1995). Most franchisors utilize master franchise arrangements by either granting an exclusive territory to operate multiple units (i.e., the area developer) or allowing an additional layer of “mini-chain” management
within franchise systems (i.e., sub-franchisor). In the agreements of area developments the area developers invest their own resources to open multiple operating units within the franchise systems; on the other hand, in sub-franchising agreements the sub-franchisors behave like a franchisor within a specific territory (Kaufmann and Kim 1995). Even though sub-franchisors do not own or directly operate sub-franchised units, sub-franchisors would directly provide initial training and ongoing services to franchisees and collect the royalty and advertising fees on behalf of the franchisor.

It is safe to assume that the large franchise systems may not have capabilities to efficiently monitor each chain member. Dant et al. (2007) found that the use of an additional layer of hierarchy in franchise systems allow franchisors to expand and grow faster. Sub-franchisors can provide insightful advice related to regional or local issues that sub-franchised franchisees bring to their attention. Additionally, if sub-franchisors acquire and integrate information and resources from sub-franchised units, then new insights and knowledge can be developed in each region. Franchisors acquire the regionally integrated insights, distribute the integrated knowledge within franchise systems, and interpret feedback from sub-franchisors. The effectiveness and efficiency of organizational learning in franchise systems would be enhanced as a result. Therefore, successful franchisors will be willing to offer sub-franchising agreements to potential or existing franchisees.

H5: Success of the franchisor is positively related to the provision of Sub-Franchising agreement.

Hypotheses Related to Strategies on Services

We develop four hypotheses related to strategies of service, operationally focused on the provision Total Initial Training days specified in the franchise contract (H6), Initial Assistances offered by the franchisors to prospective franchisee (H7), a host of Ongoing Services like inventory control, central purchasing and data processing whose costs are included in the royalties collected by the franchisors (H8), and the provision of Co-Operative Advertising that franchisors extend to franchisees (H9).

Initial training offered by experienced franchisors is a major advantage for a franchisee joining a franchise system (Peterson and Dant 1990). The new franchisee can learn codified knowledge and standardized routines through this initial training within the franchise system (Bradach 1997). Franchisors do not only transfer operational knowledge and chain-wide acculturation by providing adequate training for franchisees but also make relation-specific investment with franchisees for enhancing overall performance of the franchise systems. When all resources that are essential to operate a unit in the local market are fully understood and implemented by a franchisee, the quality of products and services provided by such a franchisee can presumably satisfy the consumers’ needs and wants. Hence, the successful franchisors invest heavily in this initial training for their new franchisees.

H6: Success of the franchisor is positively related to the length of initial training.

The firms’ decisions over integration among distribution channel members are based on the balance of two facets: (1) the autonomy of trading partners and (2) needs for cooperation and authority (Mohr, Fisher, & Nevin 1996). In franchise systems the franchisors need to find a reasonable balance between the given autonomy to the franchisees and the cooperation of the franchisees (Dant and Gundlach 1999). Presumably, the franchisees believe that by giving up autonomy for a more standardized business format the performance can be enhanced. (Mohr, Fisher & Nevin 1996). Therefore, cooperation between the franchisor and the franchisee is essential for the franchise system to grow and prosper as a network (Achrol 1996). Determining the optimal location and negotiating a successful lease are challenging tasks for inexperienced would be franchisees. The franchisors’ assistance benefits both parties, because the cooperative environment would encourage chain members to be more committed to the franchise systems. The successful franchisor-franchisee relationship can be developed by the franchisors’ assistance and the
performance of the franchise systems would be positively influenced by the healthy relationship among chain members. Thus:

H7: Success of the franchisor is positively related to the level of initial assistances extended to the franchisees.

Successful franchisors frequently choose to provide a host of ongoing services as part of the payoff for the royalty fees exacted from their franchisees. By providing such ongoing services like central data processing, central purchasing, and inventory control franchisors have the indirect controls to enhance efficiency of operating units located in distant markets and generate knowledge to forecast the performance and to achieve higher levels of productivity in the franchise system. Franchisors can prevent free-riding problems of franchisees by offering field operations evaluation, and field training would help franchisees to practice the standardized operations in the existing units (Sen 1993). Thus, success of the franchising system would be enhanced if the franchisor recognizes the importance of providing ongoing services. Hence:

H8: Success of the franchisor is positively related to the provision of ongoing services to their franchisees.

As already noted in the derivation of H2, most franchise systems recognize the usefulness of advertising and contractually bind franchisees to pay advertising fees. But the decisions on spending the pooled advertising fund are up to franchisors so that advertisement spending is controversial and can cause conflicts in inter-organizational relationships (Dant and Berger 1996). Sanderson (1995) found that franchisors and franchisees in the franchise system have different preferences over the geographic scope of advertisements in media. For example, vertical channel conflict may arise since franchisors often prefer national advertisements whereas franchisees prefer local advertisement. National advertising campaigns help all units within a franchise system; but, local advertising campaigns mainly benefit regional outlets (Dant and Berger 1996). Additionally, horizontal channel conflict may occur if the demand of advertisement varies among franchisees. Within the same franchise system, the newcomers in the system would have a greater demand for advertisements than the franchisees that have established their operating units (Dant and Berger 1996; Peterson and Dant 1990). Thus, some franchisors provide cooperative advertising and promotion allowance to minimize potential conflicts. Using the provision of cooperative advertising and promotion allowance franchisees can operate local advertising campaigns within a specific market and receive reimbursement for a part of the local advertising expenditure from their franchisors (Dant and Berger 1996; Kotler 1970). Although many franchisors doubt that local-level advertising indirectly increases brand awareness and overall sales of the franchise systems, cooperative advertising and promotion allowance for local-level advertisements can be used as a tool to diminish and to solve conflicts among chain members and to boost local morale. Therefore, the capability of franchisors to allocate some of their financial resources to local-level advertising should lead to the long term success of franchise systems. This leads to:

H9: Success of the franchisor is positively related to franchisor’s participation in local-level advertising.

Hypotheses Related to Strategies on Geography

As noted earlier, we develop and empirically examine two strategies of geography pertaining to System Dispersion strategies of the focal franchise systems in terms of number of states and provinces they operate in (H10) as well as their Prospective Expansion plans in terms of whether they have expansions planned within the U.S., Canada and Overseas markets (H11).
Rapid geographic dispersion has been cited as a key strategic and preemptive competitive advantage of growth through franchising as opposed to growth as wholly-owned corporate systems. However, several researchers have argued that capital scarcity cannot be an independent motivator for the firms to use franchising because it is based on the assumption that the acquisition of financial resources from traditional capital sources is more expensive than resources from franchisees (Norton 1995; Rubin 1978). Franchisees can be a great resource for the firms to access the local market information (Minkler 1990). It would be costly for franchisors to acquire knowledge about local markets on its own, especially in far flung markets. It is obvious that local market decisions of franchisors can benefit from the market knowledge of the local franchisees. Franchisors that appreciate franchisees as managerial and informational resources for success of their businesses would allow potential franchisees to open local outlets in any region, because in the long run the franchise system can obtain the local knowledge from such franchisees. Therefore, successful franchisors tend to permit franchisees to open local operating units in the geographically dispersed locations since franchisors can integrate more local market knowledge from such franchised units. For similar reasons, they have plans to grow not just in the contiguous USA and Canadian markets but overseas markets as well. This results in our final two hypotheses:

H10: Success of the franchisor is positively related to the geographically dispersed locations of its franchised units.

H11: Success of the franchisor is positively related to its total expansion plans for its franchised units.

**METHOD AND RESULTS**

**Sample**

This study aims to test the relationship between eleven independent variables and the success of the franchise systems. The secondary data, obtained from Bond’s Franchise Guide 2008 (Bond 2008), is employed to examine the linkages specified by the eleven hypotheses. Although the total number of respondents for the 2008 survey is 969 franchise systems, only 506 systems included complete information on all the variables under investigation. Previous cross-sectional and longitudinal studies of franchising using secondary data drawn from the Bond’s Franchise Guide has been found to yield useful theoretical insights (e.g., Baucus et al. 1993; Dant et al. 2007; Hossain and Wang 2008; Sen 1993; Shane 1998).

The dependent variable in the study is the success of franchise systems. The success of the franchise systems could be measured through various ways, such as survival of the franchise systems, total operating units, sales, and growth in the total operating units in franchise systems (Lafontaine 1992; Martin and Justis 1993; Shane 1996). In the study of Dant et. al. (2007) total system size was found to be the key driver of measuring growth and performance of franchise systems. We emulate Dant, et al. (2007) and use the total number operating units in the franchise systems (i.e., the combination of the number of company-owned and franchised units in the franchise systems), as the measure of franchise success since objective measures like financial performance of the franchise systems are not available from this database (Castrogiovanni and Justis 2002; Sen 1998; Shane 1996). Since the range of the total operating units in different franchise systems differs vastly, natural log transformation was adopted in order to improve the linearity of dependent variable.

The predictor variable measures were also directly taken from the database. We present the details of operationalizations of our variables in Table 2 and Table 3 presents the descriptive statistics and correlations of the measured variables. Some variables such as franchise fees, advertisement fees, new projected units, and total initial training, were sometimes represented as ranges of values in the database; in such cases, the mean of these ranges were calculated and entered into the analysis. Predictor variables that displayed a great degree of variation (i.e., franchise fee, new projected unit, total initial training
length, dispersion, and total operating unit) were also log transformed so that variance within such variables could be reduced. The eleven independent variables are (as shown in Table 2) are as follows: (1) franchise fee (FF) is measured as the dollar amount of the initial fee that the franchisee must pay to the franchisor to buy the franchise unit (Carney and Gedajlovic 1991; Combs and Castrogiovanni 1994; Martin and Justis 1993), (2) advertising fee (AD) is measured by the ongoing percentage of gross sales that franchisees pay franchisors for advertising, (3) experience (EXP) is measured by the number of years the franchisor has been in the franchising business, operationally, the year of database 2008, minus the year first franchised unit was sold, (4) new projected unit (NPU) represents the self-reported counts of the projected new units to be opened as envisioned by the franchisor, (5) sub-franchising (SF) is measured dichotomously as franchisors’ provision of allowing sub-franchising agreements in franchise systems (Yes=1, No=0), (6) total initial training (TT) is measured in days by the summation of all three different training times in separate locations (i.e., headquarters of franchise systems, training centers, or the franchise’s location), (7) initial assistances (AST) are estimated by summing the number of “yeses” on binary variables (Yes=1, No=0) of financial assistance, site-selection, and lease negotiation, (8) ongoing services (OS) is operationalized by counting the number of “yeses” on nine ongoing services (Yes=1, No=0) that are included in fees (see Table 2 for a list of these nine services), (9) cooperative advertising (COAD) is also measured dichotomously (Yes=1, No=0) in terms of franchisors’ willingness to run cooperative advertisements, (10) dispersion (DP) is measured by summing the number of States and Canadian Provinces where franchise systems operate, and finally, (11) prospective expansion (EP) is operated by counting “yeses” on binary variables (Yes=1, No=0) of U.S., Canada and Overseas if franchise systems plans to expand further in the U.S., Canadian, or overseas markets.
### Table 2
Operationalization of Variables

<table>
<thead>
<tr>
<th>Predictors</th>
<th>Operationalizations</th>
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<tbody>
<tr>
<td><strong>Structure</strong></td>
<td></td>
</tr>
<tr>
<td>H1 Franchise Fee (FF)</td>
<td>Average of the initial lump-sum amount of franchise fee [Log-transformed]</td>
</tr>
<tr>
<td>H2 Advertising Fee (AD)</td>
<td>Average of ongoing advertising fee (percentage of sales) that franchisees paid to the franchisor</td>
</tr>
<tr>
<td>H3 Experience (EXP)</td>
<td>Current year (2008) minus first franchise sale year</td>
</tr>
<tr>
<td>H4 New Projected Unit (NPU)</td>
<td>Projected new units to be opened [Log-transformed]</td>
</tr>
<tr>
<td>H5 Sub-franchising (SF)</td>
<td>Provision of Sub-franchising agreement on binary variables (Yes=1, No=0)</td>
</tr>
<tr>
<td><strong>Service</strong></td>
<td></td>
</tr>
<tr>
<td>H6 Total Initial Training (TT)</td>
<td>Total number of days of the initial training in all locations (i.e., headquarter, franchisee location, operation training unit) [Log-transformed]</td>
</tr>
<tr>
<td>H7 Initial Assistsances (AST)</td>
<td>Franchisors' extension of assistances--Summation of Yeses on binary variables: (1) Financial assistance, (2) Site-selection, and (3) Lease negotiation (Yes=1, No=0)</td>
</tr>
<tr>
<td>H8 Ongoing Services (OS)</td>
<td>Ongoing services provided to the franchisees--Number of ongoing services that are included in fees: (1) Central data processing, (2) Central purchasing, (3) Field operations evaluation, (4) field training, (5) Initial store opening, (6) Inventory Control, (7) Franchisee newsletter, (8) Regional or national meetings, and (9) 800 telephone hotline (Yes=1, No=0)</td>
</tr>
<tr>
<td>H9 Co-operative Ads (COAD)</td>
<td>Availability of co-operative advertising (Yes=1, No=0)</td>
</tr>
<tr>
<td><strong>Geography</strong></td>
<td></td>
</tr>
<tr>
<td>H10 System Dispersion (DP)</td>
<td>Summation of US states and Canada Provinces where franchise systems operate [Log-transformed]</td>
</tr>
<tr>
<td>H11 Prospective Expansion (EP)</td>
<td>Summation of Yeses on binary variables (1) U.S., (2) Canada, and (3) Overseas (Yes=1, No=0)</td>
</tr>
<tr>
<td><strong>DV</strong> Total Operating Unit (TOU)</td>
<td>Summation of franchised and company-owned units [Log-transformed]</td>
</tr>
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</table>
Table 3
Correlation Table

<table>
<thead>
<tr>
<th></th>
<th>Mean</th>
<th>S.D.</th>
<th>FF</th>
<th>AD</th>
<th>EXP</th>
<th>NPU</th>
<th>SF</th>
<th>TT</th>
<th>AST</th>
<th>OS</th>
<th>COAD</th>
<th>DP</th>
<th>EP</th>
<th>TOU</th>
</tr>
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<tbody>
<tr>
<td>Franchise Fee (FF)</td>
<td>3.212</td>
<td>.699</td>
<td></td>
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<td></td>
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<td></td>
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<tr>
<td>Advertising Fee (AD)</td>
<td>1.898</td>
<td>1.812</td>
<td>0.112</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
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<tr>
<td>Experience (EXP)</td>
<td>2.771</td>
<td>.787</td>
<td></td>
<td>-0.098</td>
<td>0.135</td>
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<tr>
<td>New Projected Unit (NPU)</td>
<td>2.945</td>
<td>1.305</td>
<td></td>
<td>0.029</td>
<td>0.013</td>
<td>0.016</td>
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<tr>
<td>Sub-franchising (SF)</td>
<td>0.190</td>
<td>0.394</td>
<td></td>
<td>-0.077</td>
<td>-0.003</td>
<td>0.077</td>
<td>0.062</td>
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<tr>
<td>Total Initial Training (TT)</td>
<td>2.816</td>
<td>0.858</td>
<td>0.155</td>
<td>0.241</td>
<td>0.183</td>
<td>0.077</td>
<td>0.000</td>
<td></td>
<td></td>
<td></td>
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</tr>
<tr>
<td>Initial Assitances (AST)</td>
<td>1.930</td>
<td>0.969</td>
<td>0.025</td>
<td>0.081</td>
<td>0.096</td>
<td>0.030</td>
<td>0.115</td>
<td>0.228</td>
<td></td>
<td></td>
<td></td>
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<tr>
<td>Ongoing Services (OS)</td>
<td>6.530</td>
<td>1.682</td>
<td></td>
<td>0.026</td>
<td>0.091</td>
<td>0.113</td>
<td>0.070</td>
<td>0.052</td>
<td>0.196</td>
<td>0.260</td>
<td></td>
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<td></td>
<td></td>
</tr>
<tr>
<td>Co-operative Ads (COAD)</td>
<td>0.250</td>
<td>0.434</td>
<td></td>
<td>0.086</td>
<td>0.145</td>
<td>0.039</td>
<td>0.091</td>
<td>0.008</td>
<td>0.061</td>
<td>0.080</td>
<td>0.041</td>
<td></td>
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<tr>
<td>System Dispersion (DP)</td>
<td>2.687</td>
<td>1.164</td>
<td></td>
<td>-0.052</td>
<td>0.022</td>
<td>0.440</td>
<td>0.476</td>
<td>-0.051</td>
<td>-0.050</td>
<td>-0.020</td>
<td>0.065</td>
<td>0.086</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Prospective Expansion (EP)</td>
<td>1.260</td>
<td>1.101</td>
<td></td>
<td>0.018</td>
<td>-0.008</td>
<td>0.133</td>
<td>0.286</td>
<td>0.110</td>
<td>-0.140</td>
<td>-0.020</td>
<td>0.023</td>
<td>0.049</td>
<td>0.443</td>
<td></td>
</tr>
<tr>
<td>Total Operating Unit (TOU)</td>
<td>4.550</td>
<td>1.737</td>
<td></td>
<td>-0.024</td>
<td>0.178</td>
<td>0.518</td>
<td>0.569</td>
<td>0.043</td>
<td>0.072</td>
<td>-0.056</td>
<td>0.097</td>
<td>0.110</td>
<td>0.714</td>
<td>0.312</td>
</tr>
</tbody>
</table>
To explain the success of the franchise system, we employed an ordinary-lease squares (OLS) regression model in SPSS. The use of OLS regression was appropriate given the cross-sectional nature of the data. A separate OLS regression model with non log-transformed independent variables was tested, and the findings for the significant independent variables were identical.

RESULTS

Table 4 shows the regression results. The regression model is highly significant (p < .00001) with an adjusted R²-value of .694, indicating that predictor variables explain a very significant amount of the variance in the dependent variable, the total operating units of franchise systems. The data provide strong directional support for six of the eleven hypotheses (i.e., H2, H3, H4, H5, H6 and H10). H1 (franchise fee), H8 (ongoing services), and H9 (co-operative advertising) and H11 (expansion) were found to be non-significant whereas H7 (initial assistances), while statistically significant, has the directionally opposite effect than our a priori prediction. Based on beta coefficients, the largest effects were contributed by H10 (dispersion; β = 0.441, p < .00001), H4 (new projected units; β = 0.358, p < .00001) and H3 (experience; β = 0.300, p < .00001).
### Table 4
Regression Analysis

<table>
<thead>
<tr>
<th>Predicted Direction of Effect</th>
<th>Unstandardized Coefficients</th>
<th>Standardized Coefficients</th>
<th>t</th>
<th>Sig</th>
<th>Collinearity Statistics</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>B</td>
<td>Std. Error</td>
<td>Beta</td>
<td></td>
<td>Tolerance</td>
</tr>
<tr>
<td>(Constant)</td>
<td>1.103</td>
<td>.236</td>
<td>-.003</td>
<td>-1.34</td>
<td>.989</td>
</tr>
<tr>
<td>H1 Franchise Fee (FF)</td>
<td>+</td>
<td>.000</td>
<td>.000</td>
<td></td>
<td>4.683</td>
</tr>
<tr>
<td>H2 Advertising Fee (AD)</td>
<td>+</td>
<td>.064</td>
<td>.023</td>
<td>.072</td>
<td>2.775</td>
</tr>
<tr>
<td>H3 Experience (EXP)</td>
<td>+</td>
<td>.040</td>
<td>.004</td>
<td>.300</td>
<td>10.758</td>
</tr>
<tr>
<td>H4 New Projected Unit (NPU)</td>
<td>+</td>
<td>.461</td>
<td>.037</td>
<td>.358</td>
<td>12.319</td>
</tr>
<tr>
<td>H5 Sub-franchising (SF)</td>
<td>+</td>
<td>.328</td>
<td>.103</td>
<td>.082</td>
<td>3.170</td>
</tr>
<tr>
<td>H6 Total Initial Training (TT)</td>
<td>+</td>
<td>.178</td>
<td>.052</td>
<td>.093</td>
<td>3.432</td>
</tr>
<tr>
<td>H7 Initial Assitances (AST)</td>
<td>+</td>
<td>-.121</td>
<td>.046</td>
<td>-.068</td>
<td>2.629</td>
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<tr>
<td>H8 Ongoing Services (OS)</td>
<td>+</td>
<td>.011</td>
<td>.027</td>
<td>.011</td>
<td>3.621</td>
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<tr>
<td>H9 Co-operative Ads (COAD)</td>
<td>+</td>
<td>-.086</td>
<td>.088</td>
<td>-.025</td>
<td>1.975</td>
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<tr>
<td>H10 System Dispersion (DP)</td>
<td>+</td>
<td>.041</td>
<td>.003</td>
<td>.441</td>
<td>13.373</td>
</tr>
<tr>
<td>H11 Prospective Expansion (EP)</td>
<td>+</td>
<td>-.010</td>
<td>.040</td>
<td>-.007</td>
<td>1.246</td>
</tr>
</tbody>
</table>

\[ Adj \hat R^2 = 0.694 \quad F_{(df=11,495)} = 105.550 \quad P < .00001 \]
IMPLICATIONS AND DISCUSSION

The ongoing advertising fee (H2) emerges as a statistically significant predictor of the success of the franchise system. Franchisors have the authority to collect a certain proportion of sales for advertising fee from franchisees and to strategically spend advertisement funds to run more advertisements and promotions. Ongoing advertising fees are mostly spent on running nation-wide advertisements to increase brand name reputation of franchise systems. Our result proves that more successful franchisors enjoy the economies of scale to increase their brand name reputation by running more nation-wide advertisements.

Firms’ experience (H3) of franchising is also important for franchise systems to be successful. Previous studies have looked at the importance of the concept development of firms before they franchise (i.e. Dant et al 2007); however, the importance of franchising experience has not been directly addressed. Even if a firm has a unique business concept, if the firm does not have adequate resources and capabilities to transfer the concept to franchisees, then consumers may not get the standardized quality of products and services that the firm initially developed. Also, without developing internal resources and capabilities related to franchising, the firm may have problem managing franchisees and providing standardized products and services to consumers. The firm may fail not because of business concept flaws but because of its lack of experience in managing its distribution channel system.

Franchisors with franchising experience would have developed a system to train, assist, and expand. New projected units (H4) are a significant predictor to explaining the success of a franchise system. Small and new firms use franchising to grow fast, but a successful franchisor uses franchising to grow smart. Successful franchise systems do not hang on to their current market position; instead they have plans to grow. Based on the available data, we are not clear whether new planned projected units are slated to be company-owned units, franchised units, or both. However, evidence suggests that the ratio of these two types of units does not vacillate dramatically from year to year (Blair and Lafontaine 2005). Hence one may infer that successful franchisors would control their targeted proportion of their ownership in franchise systems by opening both new company-owned and franchised units (Carney and Gedajlovic 1991).

The total initial training (H6) is also positively related to the size of franchise systems. Successful franchise systems understand the needs of trainings for new franchisees that do not have enough business experiences to operate their own units and to be profitable. During the initial training period franchisees have opportunities to acquire operational skills and to learn about products and services that they will provide to their customers. Successful franchisors obviously successfully transfer knowledge related to the standardized-operational skills and system-wide culture and climate to the local franchise units. Providing such services supports franchisees’ entrepreneurial spirits franchisor-franchisee relationships and is likely to fortify franchisor-franchisee relationships. Ultimately, the overall performance of franchise systems will be enhanced when individual chain members work toward a set of shared goals.

Even though we expected that initial assistances (H7) from franchisors would positively influence the success of franchise systems, it was found to be negatively related to the system success. Since franchisors have better knowledge on site selection and lease negotiation, they were expected to assist franchisees with such capabilities and thereby develop strong dyadic relationships, hopefully translating into system growth. It may be that successful franchisors believe that such assistances only benefit the franchisees in the short-run, and hence do not have a direct impact on system growth. Alternatively, the effects of such initial assistances may be limited to generating strong dyadic bonding and not necessarily translate into system growth. Finally, successful franchisors may believe that developing franchisees’ own skills to select good locations and negotiate leases can help franchisees to emotionally prepare for their new businesses and to take responsibility for their decisions.
Our hypotheses related to ongoing services (H8) and co-operative advertising (H9) are not statistically significant. We had expected that prospective franchisees would be interested in receiving ongoing services from franchisors and the partial reimbursements for their local advertising expenditures. These results do not necessarily indicate that franchisors do not have to provide ongoing services and co-operative advertising services to be successful. This lack of significance may be the result of the fact that most franchisors offer ongoing services and local advertising supports to their franchisees. Hence, even though there are no significant relationships between the system success and these two service variables, we would counsel the franchisors to continue to offer at least some basic levels of ongoing services and co-operative advertising supports to their franchisees.

We expected to see that the geographical dispersion of franchise systems would lead to the growth of franchise systems since new franchisees can bring local information into the franchise system from the perspective of resource scarcity theory. Franchisors’ plans of further expansion into the U.S., Canada, and overseas markets are not significantly related to the success of franchise systems (H11). Note that this variable was estimated by summing the dichotomous variable across the three markets (see Table 2). However, this operationalization may not have fully the true variability of system expansions. In other words, if we had actual counts of expansions planned in these three markets (regrettably, this is not available in Bond’s database), we believe our a priori hypothesis would have been supported. On the other hand, because the number of States and Canadian provinces where operating units of franchise systems are located at (H10) captures greater level of variability among franchise systems, we found the statistical support for H10 linking geographical dispersion and the success of franchisors using this particular variable. The result shows that the successful franchisors tend to either operate company-owned units or to franchise units in many different States and Canadian provinces as opposed to their less successful systems.

Based on the perspective of resource based theory we can interpret the results as showing that successful franchisors are willing to expand the franchise systems in the places where the franchisors do not have resources and capabilities to successfully implement their system concepts. In other words, the success of franchisors might be greatly improved by bringing new local market information and resources from franchisees in dispersed markets. By expanding franchise systems in heterogeneous regions franchisors seemingly appear to adapt to new market environments and to strengthen their proven system concepts, products, and services. However, the acquired resources can neither be efficiently nor be effectively internalized without the organizational learning culture in franchise systems. For example, the variation of market environments is great if the operating units in franchise systems are located in geographically dispersed areas. Some franchisors that cannot quickly acquire local information, integrate new information into their systems, and flexibly respond to the local market environments will be less likely to succeed when they compete with other franchisors that have capabilities to utilize the process of organizational learning. Therefore, the geographical distance will not constrain the expansion of the successful franchisors.

CONCLUSIONS
The primary purpose of this study was to investigate how strategic resources and capabilities are related to success of franchisors. Based on the conventional theory (i.e., resource constraints theory and agency theory), a new and small firm uses franchising to grow faster, and the financial resources, managerial resources, and regional information from franchisees could be great assets for the start-up franchisor firm. It explained why firms use franchising for their growth and various scholars have argued that established and successful franchisors would desire to have full ownership of the entire system by purchasing back franchised units (Oxenfeldt and Kelly 1969). In contrast, Lafontaine and Kaufmann (1994) found that some franchisors continue the plural system of operating both company-owned units and franchised units, a finding further corroborated by Dant and Kaufmann 2003). In our study, we attempted to explain how firms can be successful by learning, developing, and implementing knowledge
and resources within franchise systems. These unique capabilities of franchisors that stem from their accumulated learning and knowledge can and should be considered as the most precious strategic resources under the control of franchisors. We also believe that the plural form governance structure (i.e., simultaneously operating both company-owned units and franchised units) allows franchise systems to develop richer insights into the management of their business and greater opportunities for shaping an organizational culture and climate that fosters chain members to participate in organizational learning (Sorenson and Sorensen 2001).

We believe that applying the organizational learning perspective to the resource based view of successes of franchisors continues to have great potential for future research (Combs, Michael, and Castrogiovanni 2004). In the direction of future research agenda, we exhort scholars to test whether franchisors’ perspectives on franchising change over different stages of the life cycle in franchise systems. In addition, future research can fruitfully address whether franchisors employ their strategic plans crafted in the North American to enter and to expand in foreign markets. It may be safely predicted that the organizational learning impact of the cumulative foreign market experience of franchisors operating overseas would be profound and likely to propel such learning organizations to even higher levels of success.

Finally, we recognize the usual limitations associated with relying on a secondary data source as opposed to primary data. However, we also note that gathering such primary data across all franchising sectors within the U.S. economy would be a phenomenally prohibitive expense and would probably be beyond the reach of most academic researchers. As to the issue of whether Bond’s directory is the optimal data source to utilize in such an investigation, we note that many franchising scholars have used the secondary data compiled by the Bond directory. An alternative is the Entrepreneur magazine data. Based on our knowledge, the Entrepreneur magazine data appears to be biased toward larger size franchise systems. Thus, Entrepreneur magazine data could be skewed and we may not be able to test the overall growth strategies of franchise systems. In addition, the variable lists available from the Entrepreneur magazine data are severely limited as compared to the Bond’s directory. Consequently, we felt that the Bond directory would be appropriate data source for the purposes of the study. Unfortunately, beyond this, we are not able to compare the Bond directory data to other resources of secondary data since such economy-wide data simply do not seem to exist for the USA franchising industry.
REFERENCES


RESPONSES TO POSITIVELY INEQUTABLE ACTIONS: HOW CUSTOMER DELIGHT IMPACTS PERCEIVED RELATEDNESS

Christian Hinsch and Donald Lund, University of Missouri

ABSTRACT

Customer satisfaction does not explain or account for customer’s future behaviors, especially in terms of retention. Customer delight has been proposed as a variable that can better predict important marketing variables like loyalty and profitability. The psychological outcomes that accompany consumers’ better than expected (delighting) experiences are under researched. This research utilizes Self Determination Theory to better understand the consequences of receiving these better than expected outcomes.

Using the 6 dimensional NSAT scale to record positive and negative dimensions of the three SDT needs, the results show that better than expected outcomes affect the individual through felt positive relatedness. Interactions are explored with subject’s reported norms for positive and negative reciprocity. Counter intuitively, it appears that a strong norm of positive reciprocity counteracts the hypothesized increase in positive relatedness after receiving a “delighting” experience. Implications for customer delight, relationship marketing, and reciprocal norms are discussed.

INTRODUCTION

There is little doubt that keeping customers satisfied will result in benefits for the firm. These benefits include customer retention and loyalty (Brakus, Schmitt, & Zarantonello, 2009), increases in share of wallet (Cooil, Keiningham, Aksoy, & Hsu, 2007), and profitability (Bowman & Narayandas, 2004). Several authors have questioned the logic of using satisfaction measures to predict success since nearly one quarter of satisfied customers defect (i.e. Berman, 2005; Jones & Sasser, 1995). The concept of customer delight has garnered increasing interest in terms of predicting a firm’s success, especially in terms of predicting customer loyalty (Chitturi, Raghunathan, & Mahajan, 2008; Keiningham, Goddard, Vavra, & Iaci, 1999). Customer delight is derived from exchanges where the customer is not only satisfied, but receives an outcome that provides unexpected value and unanticipated satisfaction (Chandler, 1989; Oliver & Rust, 1997). We are unaware of empirical research that uncovers the mechanisms through which delighted customers create value for the firm.

Relationships have long been a focus of the science of marketing. Exchanges are embedded in relationships of one form or another. Markets are social spaces that require interaction between individuals (Storr, 2008). This research shows a clear linkage between receiving better than expected exchange outcomes and feelings of relatedness to others. The results of this research also show how financial incentives are translated into social responses, a way of justifying the contention that there are three types of relationship marketing efforts: financial, social and structural (Berry & Parasuraman, 1991). An unexpected financial reward results in increased felt relatedness for the individual, a social outcome from a financial stimulus.

Relatedness is a variable that is becoming increasingly important in the modern world. Many theorists believe that technology is replacing face to face interpersonal contact (e.g. Putnam, 2000). Other researchers have shown empirically that close personal contacts have become more scarce (McPherson, Brashears, & Smith-Lovin, 2006), and that face to face time with others has declined as time in front of a computer screen has increased (Sigman, 2009). Therefore, then it seems likely that individuals will seek interaction and relatedness in other ways. The need to belong (Baumeister & Leary, 1995) must be met in some way, and the marketplace is one context in which individuals can choose to fulfill this need.
Many theories of motivation propose base level needs that individuals feel pressure to fulfill. In a handbook chapter dedicated to basic human needs and motivation, Pittman and Ziegler (2007) outline six of the most prominent theories in this area. Maslow’s hierarchy of needs (1948), Epstein’s Cognitive-Experiential Self theory (Epstein, 1994), Fiske’s Core Social Motives Theory (Fiske, 2004), Bowlby’s Attachment Theory (Bowlby, 1978), and even Greenberg’s Terror Management Theory (Mikulincer, Florian, & Hirshberger, 2004) have placed relationships as a primary motivator of human behavior. This chapter also outlines Self Determination Theory (SDT) which proposes that individuals focus on fulfilling three main needs: the needs of autonomy, competence and relatedness (Deci & Ryan, 2000). The relationship marketing paradigm has been part of the marketing literature for decades and it has become clear that relationship creation is a way that marketers can more closely connect with consumers. This research will explore how different types of behaviors exhibited in an exchange relationship can change individual’s perceptions of felt relatedness.

It is expected, and shown empirically, that the translation of unexpectedly positive outcomes to social connectedness will not occur uniformly for all groups. We segment our sample based on adherence to the norm of reciprocity, a primary component of relationship marketing theory. We find that adherence to the norm of positive reciprocity does moderate the translation of financial benefits to relatedness while the norm of negative reciprocity has no effect.

**STUDY OUTLINE AND HYPOTHESES**

It is no secret that many first world economies have shifted from a goods focus to a services focus (Oliver & Rust, 1997). Still others suggest that all marketing activities be viewed from the perspective of services (Vargo & Lusch, 2004). Many aspects of services have made them a point of convergence for potential social interactions including the often simultaneous production and consumption of the service or interaction through co-production. Many service delivery experiences require that line level employees and consumers work in close contact. The need to belong can be met through service delivery as other opportunities for face to face interaction become scarcer. In this research we investigate how a reciprocal exchange may affect a person’s felt relatedness. Further, we view an individual’s norm of positive reciprocity as a potential moderator to their perception of relatedness in the wake of a reciprocal exchange.

Macneil (p. 38, 1980) defines a norm as “a principle of right action binding upon the members of a group and serving to guide, control, or regulate proper and acceptable behavior.” An important implication is that norms not only suggest behavior that is appropriate for an individual, but also help to define expectations about the behavior of other individuals one might interact with. It is important to realize that norms do not define actual behavior; rather they portray what we ought to do, and what we should expect from others in a particular context (Richard P. Bagozzi, 1992). Differences in actual behavior in the face of a reciprocal exchange can be explained in part by the individual’s propensity to adhere to particular social norms (Perugini, Gallucci, Presaghi, & Ercolani, 2003).

The norm of reciprocity is the glue that holds society together. Social interactions are dependent on a reciprocal tension that sets borders and limits on individual’s opportunistic behavior. Though there are arguments about the existence of altruism in the social science literature (Charles Daniel Batson, 1991; C. Daniel Batson, et al., 2007; Cialdini, Brown, Lewis, Luce, & Neuberg, 1997; Neuberg, et al., 1997), the self interested avoidance of negative outcomes, or the attraction of positive outcomes via reciprocal feedback creates a strong alternative explanation for many apparently altruistic acts. Perugini et al. (2003) find that people differ in their adherence to the positive norm of reciprocity, and that those with a stronger adherence to this norm (a) pay closer attention to the actions of others that benefits them, and (b) tend to behave more favorably in response to those actions. We expect degree to which the norm of reciprocity is felt by the user to impact his/her felt relatedness with others.
The marketplace allows consumers to reciprocate a firm’s actions in a variety of ways. For example, a consumer can reciprocate a positive experience by making a purchase, returning to make additional purchases, or by engaging in positive word of mouth. Negative actions can be reciprocated in much the same way as consumers can bash the firm in person or online, create havoc in the delivery process, reduce their purchase quantity or frequency, or even bring legal action against a firm.

The focus of this paper is on positive actions and the changes that take place within the consumer when s/he encounters a situation where s/he is treated better than s/he would treat others. Specifically, from relationship marketing theory, we expect that subject’s transient state of felt relatedness will be affected by the type of treatment that they receive from others. More specifically, we expect felt relatedness to increase when an individual is treated better than s/he expects while there should be no change if the subject’s partner directly reciprocates the subject’s action.

H1: Felt relatedness will increase when an individual receives treatment that is better than what s/he would give others.

The positive norm of reciprocity (L. C. Becker, 1986) states that individuals should make efforts to repay any benefits received through the actions of others. Theorists argue that this norm is responsible for the development of social institutions, as the obligation to repay beneficial actions creates a social glue that binds individuals together (H. Becker, 1956; Gouldner, 1960). An individual with a strong belief in the positive norm of reciprocity should be more likely to consciously recognize the need to reciprocate beneficial actions of their partner.

Other researchers have extended the definition of reciprocity beyond the conception of consistent beneficial reactions. Eisenberger and colleagues (2004) find support for a negative norm of reciprocity as an individual difference variable which helps explain why some people tend to punish more severely than others. They define the negative norm of reciprocity as “a unitary set of beliefs favoring retribution as the correct and proper way to respond to unfavorable treatment” (p. 788). Gouldner (1960) also incorporates retaliation in his explication of the norm of reciprocity, noting that reciprocity can refer to the return of both benefits and harms.

The norms of positive and negative reciprocity will predict the level of felt relatedness after our manipulation.

H2a: Adherence to the positive norm of reciprocity will positively predict felt relatedness.

H2b: Adherence to the negative norm of reciprocity will negatively predict felt relatedness.

When given an outcome that is better than a subject would have given, those higher in the norm of positive reciprocity will be more likely to increase in felt relatedness. These individuals hold the core value that positive behaviors displayed by others should be repaid with positive responses. As such, receiving a positive response should result in a greater increase in felt relatedness consistent with this core belief. In effect, the better than expected action taken by a subject’s partner will result in a reciprocal debt that will engender feelings of relatedness. Humans are a cooperative species and better than expected outcomes will increase our sense of belonging and highlight our relatedness to others.

H3: Those high in the positive norm of reciprocity will display a larger increase in positive relatedness after receiving a positive outcome than those with lower adherence to the positive norm of reciprocity.
Giving individuals better than expected outcomes will result in the generation of goodwill which theoretically should lead to relationship commitment. This goodwill will be evidenced through increases in felt relatedness as these individuals have no way to directly repay the experimental outcomes.

MEASURES

Recognizing that the norm of reciprocity includes not only positive reciprocation, but also retributive punishment, or negative reciprocity as a moral imperative, Perugini et al. (2003) conceptualized the norm of reciprocity as a two part internalized social norm. The “Personal Norm of Reciprocity” scale measures individual adherence to norms of both positive reciprocity and negative reciprocity. The authors find evidence that individuals with higher positive or negative reciprocity norms behave differently in interactions with others depending on the perceived valence of the others’ past behavior. In other words, individuals exhibit different levels of adherence to the norm of positive and negative reciprocity, and these norms influence their behavior differentially in relationships. People with a stronger belief in the positive norm of reciprocity tend to pay more attention to others’ actions that benefit them, and tend to repay their reciprocal obligations by doing more in return, than those who have a lesser adherence to the positive norm of reciprocity.

We measured participants’ belief in the positive and negative norms of reciprocity with 12 items (6 each) adapted from Perugini et al. (2003), captured on a 7-point scale anchored by 1 (Strongly Disagree) to 7 (Strongly Agree). The norm of reciprocity is an individual difference variable. People expect to receive as well as give others different levels of treatment for both positive and negative actions. At the conclusion of a specific exchange interaction, we expect that those high in the norm of positive reciprocity will be more connected and feel more related to others while those high in negative reciprocity will generally feel less connected.

As mentioned above, there are many different psychological theories that incorporate the role of relatedness into theories of motivation. As such, scientists in the 21st century have a diverse choice of instruments that can be used to measure this construct. In this research the Need Satisfaction Inventory (NSAT) developed by Sheldon and Gunz (2009) was used for this purpose. There are two primary reasons that this measure was chosen. First, much empirical evidence that supports the SDT models contribution to positive psychological outcomes (i.e. Deci & Ryan, 2000; Sheldon, Elliot, Kim, & Kasser, 2001). While one would be mistaken to say that SDT is presently the dominant psychological theory of motivation, it is considered one of the dominant theories in present day social psychology.

The second reason that this measure was chosen for relatedness was because the NSAT measures relatedness on both the positive and negative dimensions. Following the pattern of the Positive and Negative Affect Schedule (PANAS) (Watson, Tellegen, & Clark, 1988), the creators of the NSAT realized the multidimensional nature of this construct. These positive and negative dimensions can often confound each other and compete for variance in statistical tests. It is only when the dimensions are separated that a researcher can truly see the impact of a stimulus or a manipulation.

To measure relatedness we used the NSAT on a 1 (strongly disagree) to 7 (strongly agree) scale. The measure is comprised of 3 items for each of the positive and negative measures of autonomy, competence and relatedness.

STUDY DESIGN

94 undergraduate students (46 men, 46 women, 2 declined to answer the gender question) were involved in this study in exchange for course credit. These subjects were brought together into a room and split into two random groups. One group was moved to a different room in the building. Subjects were instructed that they were being paired up with a member in the other room with whom they would then play a game. The objective of the game is to end the game with the most money. The subjects were split
from a single large group to maintain the illusion that they were actually playing other subjects. In reality, these individuals were receiving scripted responses generated by the experimenter.

After filling out an initial survey to ascertain baseline levels of the variables of interest (reciprocity norms and relatedness), subjects in both rooms were instructed that a coin was flipped and their group was chosen to act first in the game. The game involved transferring money between the players, but the details of the transfer are not important for the purposes of this research. The different treatments that each group received in the experiment are important. Remember that even though the subjects thought they were competing with other subjects, an experimenter was actually responding to the transfers that subjects made. These experimenter initiated responses were made in two different ways. Group one received an experimenter’s response of a transfer that was identical to the subject’s initial transfer. We will call this the equitable group since these subjects received a response that was identical to what would be expected in a fair and equitable world.

Group two received a response from the experimenter that exceeded the subject’s initial transfer by three dollars. We will call this group the inducement group since they received an outcome that was over and above what might be considered to be just or fair. After completing three rounds of the game in either the equitable or the inducement groups, subjects were asked to complete a final questionnaire recording our variables of interest.

RESULTS

Hypothesis one stated that positive felt relatedness would increase for those in the inducement group, and it would remain unchanged for subjects in the equitable group. Figure One displays the means for positive relatedness for both the inducement and equitable group at time one and time two. The results of two between subjects ANOVAs run in SPSS revealed that there was an insignificant difference between the groups at T1 (F (1, 91) = .156, p=.694) and a significant difference at T2 (F (1, 93) = 5.037, p=.027).
Hypothesis two suggests that positive relatedness will be predicted by an individual’s adherence to the norm of reciprocity. A regression using both the positive and negative norms of reciprocity to predict the degree of felt relatedness gives support for this hypothesis. The norm of positive reciprocity is positively related to the level of felt positive relatedness at time two (Beta=.323, t=3.312, p=.001) and the norm of negative reciprocity is negatively related to this value (Beta=-.305, t=-3.128, p=.002). Together, these analyses show strong support for the assertion that the positive and negative norms of reciprocity have a large impact on felt relatedness; however, a closer look at this data reveals an interesting interaction. Using the positive norm of reciprocity as a predictor of felt relatedness displays a strongly significant relationship at T1 (Beta = .479, t=5.025, p <.001, $R^2 = .215$). This shows that as a rule, people who are high in the norm of positive reciprocity generally feel more positive relatedness than those who are low in the norm of positive reciprocity. This pattern is also evident in the equitable group at T2 (Beta=.464, t=3.436, p=.001, $R^2 =.215$). The interesting finding lies in the fact that the norm of positive reciprocity loses the power to predict relatedness for the group that received a beneficial outcome (Beta=.097, t=.629, p=.533, $R^2 =.009$). Potential reasons for this loss of explanatory power will be discussed below.

At the same time, the norm of negative reciprocity is negatively associated with felt relatedness at both T1 (Beta = -.180, t=-1.723, p=.088, $R^2 =.038$) and T2 (Beta=-.271, t=-2.685, p=.009, $R^2 =.073$) though the relationship has much less predictive power. There is little difference between the beneficial and equitable group proving that the manipulation (inducement or equitable) had no effect on the relationship between the norm of negative reciprocity and felt relatedness.

The argument for the third hypothesis was made to explain the mechanism through which the norms of reciprocity impacts felt relatedness. It was predicted that individuals who are high in the norm of positive reciprocity will be more likely to display an increase in felt relatedness after receiving a better than equitable outcome from their partner. First, we ran a regression with the main effects of the manipulation group (inducement or equitable), adherence to the norm of positive reciprocity, and adherence to the norm of negative reciprocity. The results of this regression are reported in table two.

**Table Two**

<table>
<thead>
<tr>
<th>Predicting the change in Positive Relatedness from T1 to T2</th>
</tr>
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<tbody>
<tr>
<td><strong>Standardized Coefficient</strong></td>
</tr>
<tr>
<td>Constant</td>
</tr>
<tr>
<td>Grouping Variable</td>
</tr>
<tr>
<td>Norm of Pos Recip</td>
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<tr>
<td>Norm of Neg Recip</td>
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</tbody>
</table>
As you can see, the manipulation group is positive and marginally significant showing that subjects who received the beneficial outcome were more likely to feel additional positive relatedness when controlling for both norms of reciprocity. The norm of positive reciprocity is negative and highly significant showing that individuals high in the norm of positive reciprocity feel less relatedness when controlling for the treatment group and the norm of negative reciprocity. The norm of negative reciprocity had no main effect on relatedness change when controlling for the other to variables.

As outlined above, we expected the norm of positive reciprocity to interact with the manipulation group and enhance the effect of the beneficial manipulation. To test this hypothesis a linear regression was run with the norms of positive and negative reciprocity, the grouping variable (inducement or equitable) as well as interaction terms for both the positive and negative norms of reciprocity with the grouping variable. These variables were used to predict the change in positive relatedness from time one to time two. The results of this analysis are displayed in Table Three.

Table Three

Predicting the change in Positive Relatedness from T1 to T2

<table>
<thead>
<tr>
<th>Constant</th>
<th>Standardized Coefficient</th>
<th>t</th>
<th>Sig</th>
</tr>
</thead>
<tbody>
<tr>
<td>Grouping Variable</td>
<td>2.867</td>
<td>3.368</td>
<td>0.001</td>
</tr>
<tr>
<td>Norm of Pos Recip</td>
<td>0.115</td>
<td>0.843</td>
<td>0.402</td>
</tr>
<tr>
<td>Norm of Neg Recip</td>
<td>-0.267</td>
<td>-1.915</td>
<td>0.059</td>
</tr>
<tr>
<td>NPR X Group</td>
<td>-3.232</td>
<td>-3.912</td>
<td>0.000</td>
</tr>
<tr>
<td>NNR X Group</td>
<td>0.483</td>
<td>1.580</td>
<td>0.118</td>
</tr>
</tbody>
</table>

The results of this analysis were not in line with our predictions in Hypothesis 3. Table three shows that there is a strong main effect for the manipulation. This finding provides reinforcement for hypothesis one that by awarding better than equitable outcomes we can elicit feelings of relatedness in our partners when controlling for the other variables. The next highly significant finding relates to an interaction between the positive reciprocity norm and the grouping variable. Hypothesis three predicted an interaction here, but it was predicted to be positive. It seems that those who are high in the positive reciprocity norm are less likely to experience an increase in felt relatedness after they experience a better than equitable exchange. This counterintuitive finding will be discussed further below.

Finally, the negative reciprocity norm approaches significance in this full model and the negative reciprocity norm’s interaction with the grouping variable is approaching marginal significance. All of this evidence points to a rejection of hypothesis three as well as an explanation for how felt relatedness changes when presented with outcomes that are better than should be expected in an equitable world.
DISCUSSION

In refuting hypothesis three, this research shows that individuals’ felt relatedness is influenced by receiving better than expected outcomes, but the felt relatedness of individuals high in the positive norm of reciprocity actually decreased with our manipulation. One possible explanation for this is that the inducement group received benefits that they were unable to repay through the course of the experiment. Those who are high on the positive norm of reciprocity may experience discomfort consistent with cognitive dissonance (Festinger, 1957) based on their obligation to repay benefits received, without an effective means to reciprocate with their anonymous partner. In the course of an ongoing relationship, this finding may be unexpected, however in a laboratory setting with an unknown partner, the inability to reciprocate benefits received may negatively impact the relatedness felt by participants due to their strong belief that they are obliged to do so.

Another possible explanation for these findings can be found in the statement *quid pro quo*. Individuals high in the norm of positive reciprocity may share the belief that “there is no such thing as a free lunch”. If someone provides me with a better than expected outcome, it is only because they expect to receive something back at some point in the future. Most likely, the future payment will exceed the value of the present benefit so receiving the better than expected outcome is best interpreted as a net loss. In essence, individuals who are high in the norm of positive reciprocity would rather not have the better than equitable outcome because this outcome requires repayment at some future date. Better than fair treatment for these individuals is viewed negatively. The cost of paying future goodwill is not worth the value of the better than expected outcome.

The increase in positive relatedness cannot be explained by those who are high in the norm of negative reciprocity either. This variable is marginally significant in the regression equation but it is directionally negative. It would make sense that this negative reaction arises from a feeling of manipulation by individuals who are high on the norm of negative reciprocity. If we accept the potential explanation for the negative interaction of positive reciprocity norm and grouping, then the direction of the negative norm and group interaction makes sense as well. Given “extra” benefits over the course of an interaction, these individuals do not feel a similar need to reciprocate, nor do they feel an increase in relatedness from interaction.

This research shows that providing better than expected outcomes can change individuals’ perceptions of relatedness. A significant portion of relationship marketing is focused on developing relationships between individuals who are agents of a firm and individuals who are consumers of products. This research shows that providing better than equitable outcomes can positively impact some individual’s sense of relatedness. Surprisingly, this impact does not arise in those who are high in either the positive or negative norm of reciprocity. Instead, it appears that individuals who are more neutral in their stance on reciprocity are more affected by better than expected outcomes in terms of positive relatedness. This is good news for relationship marketers as it is expected that these subjects will follow a normal distribution.

Additionally, this is the first known study to empirically show that delighting customers results in the base level fulfillment of a need for relatedness. This meshes well with relationship marketing theory which can be divided into financial, social and structural elements (Berry, 1995). Though the experiment outlined in this research was not embedded in a consumption setting, the manipulation can be considered to be most like a financial relationship marketing effort. Subjects were given a (fake) financial reward and they developed feelings of relatedness.

Much recent effort has been made to establish the bottom line effectiveness of relationship marketing efforts (Bolton, Kannan, & Bramlett, 2000). One recent study found that social relationship marketing efforts provide a high payoff while financial efforts do not (Palmatier, Gopalakrishna, &
Houston, 2006). The current research links an individual’s financial benefits to changes in social perceptions. This demonstrates that the returns from both types of efforts are generated by social forces; empirically establishing financial incentives as a viable relationship marketing strategy.

LIMITATIONS

The most obvious limitation from this study arises from the design of the experiment. Subjects are instructed that they are engaging in a game with another individual, not interacting in a purchase or service delivery encounter. Several theorists have proposed that marketing and consumption are really based on simple exchange (i.e. R. P. Bagozzi, 1975). In fact, the AMA accepted definition of marketing was centered on exchange for decades (Hunt, 1976). Extending the results from this exchange to relationship marketing efforts is something of a stretch, but it is a stretch that is supported by past marketing literature.

To address this “elephant in the room” we plan to run an additional scenario study where subjects will envision exceptional and average treatment by a service provider. Results consistent with the present study should serve to validate our extension of this study to financial relationship marketing efforts.

CONCLUSION

This research utilized a simulation experiment to address the outcomes from an individual being “delighted” with a better than expected result. The results show that receiving the better than expected outcome results in increased feelings of positive relatedness in most subjects. Surprisingly, those high in the norm of positive reciprocity did not register higher levels of positive relatedness after receiving the better than expected outcome.

The level of relatedness is positively predicted by the positive norm of reciprocity and negatively predicted by the negative norm of reciprocity. Adherence to the positive norm of reciprocity moderates how beneficial financial outcomes are viewed. This suggests that individuals have different predetermined tendencies to translate “delight” inducing experiences into feelings of relatedness. The fact that the main effect for the positive reciprocity norm drops out with the addition of an interaction term between the norm of positive reciprocity and the grouping variable suggests a more intricate relationship. Counter intuitively, this interaction term is negative showing that those who were higher in the norm of positive reciprocity did not have increased feelings of relatedness after receiving a better than expected, delighting outcome.

This research provides insights about the outcomes of “delighting” experiences. Prior research has shown the link between delighting customers and loyalty. It seems clear that loyalty is a result of felt increased relatedness that occurs within the individuals who are “delighted” by receiving better than expected outcomes. Additionally, we supply the first empirical evidence that explains how financial measures are tied to relationships with customers.
REFERENCES


THE CONDITIONED IMPACT OF ECONOMIC NEWS AND THE REAL STATE OF THE ECONOMY ON CONSUMER CONFIDENCE BEFORE, DURING AND AFTER RECESSIONS: A HOLISTIC LOOK AT SECOND-LEVEL AGENDA-SETTING ACROSS TIME

Lishan Su, Iowa State University

ABSTRACT

This study explored the relationships among economic news, consumer perceptions toward the economy and the real state of the economy from January 1997 to December 2006, which included three time segments: (1) before a recession; (2) during a recession; (3) following a recession. Using time series analyses, this empirical study concludes that: (1) levels of economic news’ second-level agenda-setting effects on consumer confidence depended on different economic conditions; (2) instead of a “mirror-image” model, an “audience-contingent effect” model was supported, which suggested that economic news was a trigger stimulus, and audience sensitivities under different economic circumstances were modulators, of media’s agenda-setting effects.

INTRODUCTION

The 2007-2010 financial crisis has generated interest in how real economic change and mass media coverage of the economic situation affect levels of consumer confidence. Since the U.S. economy is heavily dependent on spending by consumers, factors that lower consumer confidence would have negative impacts on the economy as fearful consumers reduce spending and increase saving. Government actions have been taken to shore up consumer confidence as well as financial institutions. Because of the importance of the issue, a number of studies have been carried out in previous years. However, each study has had its own strengths and weaknesses, and the area remains ripe for additional analysis. The present study improves on previous research in several ways: (1) It includes time periods before, during, and after an economic recession to shed light on whether or not effects of mass media coverage are more powerful at one time than another; (2) It focuses on second level agenda-setting effects; (3) It uses Granger causality analysis—a power longitudinal analysis tool—to examine trends across time.

LITERATURE REVIEW

Agenda-setting theory has commonly been used to examine the relationship between certain levels of mass media coverage and resulting public assessment of the importance of media topics. The essence of this theory is that mass media have the power to tell the public “what to think about” (McCombs and Shaw, 1993). More recently, scholars have gone beyond the theory’s “first level” effects to posit that mass media have “second-level” effects such as telling people how to think about an issue, and what to think (Kiousis, 2005; Kiousis & McCombs, 2004). In contrast to objects (i.e. issues, political candidates, etc.), second-level agenda setting shifts its attention to perspectives or frames that journalists and the public employ to think about each object. These perspectives can direct people’s attention to or away from the attributes of objects. The selection of objects for attention and the selection of frames for thinking about these objects both demonstrate the powers of agenda setting. Journalists’ judgments of an item’s newsworthiness can make them frame issues in a broad range of ways (McCombs & Shaw, 1993).

A few studies suggest that media do have effects on consumer sentiment. Alsem, Brakeman, Hoogduin and Kuper (2004), who studied the Dutch newspapers’ reporting on the economy, found that public sentiments could be magnified by the “spin” that the media give to their stories. The spin results from the competition to write memorable stories. Consequently, it can be surmised that consumer sentiment can be affected not only by economic fundamentals, but also by the way these fundamentals are reported in the media.
However, other studies suggest that news coverage only has limited effects on the public’s perception of the economy. Haller and Norpoth (1997) analyzed data from 1979 to 1990 using both cross-sectional and time-series designs. They found that close to half of American public admits not getting any economic news. More importantly, news exposure was found to be not particularly helpful in significantly improving people’s ability to evaluate economic situations since the aggregate opinion of “no-news” respondents closely matched the opinion of the respondents exposed to economic news. Rather, they found that the indicators of real economic condition such as inflation and unemployment contributed more to the public opinion of the economy.

One study investigated whether or not cycles of coverage would make a difference in whether or not agenda-setting effects occurred. In a study designed to determine the relationship between economic media coverage and public opinion, Stevenson, Gonzenbach and David (1994) identified cyclical effects between media coverage of the economy and people’s perception of the economy. Controlling for real-world economic indicators, they found that public opinion at first strongly influenced corresponding media coverage. However, the media then reacted to public opinion and were actually found to exert influence on public opinion only at a later date.

Erbring, Goldenberg & Miller (1980) investigated the possibility that differences among audience members (whether they are members of a union, or likely to be involved in job layoffs, etc.) would affect how they might be impacted by news media coverage of economic events. They tested a “mirror image” model idea that mass media coverage would be able to impact public opinion. However, they found that results depended on real world conditions and individual characteristics as modulators (an “audience-contingency” condition). When an audience was actively concerned about a topic such as unemployment, news coverage could have an impact. Yet they only focused on first-level agenda-setting.

Other researchers focused on the possibility that mass media might have an impact when they provide negative economic news, but not for positive news. When conducting content analysis of economic news coverage on the front pages of the New York Times from 1981 to 1992, Goidel and Langley (1995) used a measure of a news story’s tone (positive or negative), the same month’s measurement of public opinion and the same month’s indicators of the real state of economy, and then concluded that media tend to follow negative economic conditions more closely than positive economic conditions. They also found that news coverage of the economy—particularly negative coverage—does have a significant influence on public opinion even after controlling for the effects of real-world economic indicators.

Hester and Gibson (2003) studied the specific influence of the tone of media coverage on general public perception of current and future economic performance from a second-level agenda-setting perspective and through time series analysis by analyzing the content of economic news coverage on ABC World News Tonight broadcasts and the front page of the New York Times. They found that news coverage framed the economy more in negative terms. They found no evidence to support the hypothesis that negatively framed news stories about the economy would be a more significant predictor of attitudes toward current economic conditions than positively framed news coverage. However, their results strongly supported the hypothesis that negatively framed news coverage of the economy is a better predictor of corresponding attitudes toward future economic conditions than positively framed news coverage. Their argument is that people use personal experiences to make judgments whenever possible, but rely more on the media for issues out of their reach.

Two studies discussed whether impacts of mass media coverage might differ based upon the time period. The idea was that coverage might have more of an impact during an economic downturn rather than in normal times. Using advanced vector auto-regression analysis (VAR), a method of time series analysis, and tests for Granger causality, Blood and Phillips (1995) analyzed the four variables, recession
headline news, consumer sentiment and the state of the economy as well as presidential popularity. Recession headline data were collected by counting the number of headlines containing the word “recession” that appeared each month in the New York Times from 1989 to 1993, during which there is the 1991 recession. They found that recession headline news did have a causal effect on consumer sentiment in this time frame, but there was no evidence that the real state of the economy had an impact on consumer sentiment, and recession headline news was not influenced by the real state of the economy. Based on Blood & Phillips’ study, Wu, Stevenson, Chen & Guner, (2002) extended the examination to the time frames of both recessions and normal times. They examined the relationships of the three variables, recession headline news, public perceptions toward the economy and the state of the economy through the New York Times from January 1987 to March 1996 using VAR analysis. Using the Chow test, they divided the 111 months into two time frames: the downturn period from January 1987 to December 1990 and the recovery period from January 1991 to March 1996. They found that media coverage could be a good predictor of the public’s assessment of the economy during downturn periods even after the state of the economy was controlled for. They suggested that individuals pay greater attention to economic news during times of economic slowdowns. In other words, the impact of recession news on the public opinion of the economy depends on different economic circumstances. Yet neither of these two studies measured and compared impacts of economic news before, during and after recessions.

The literature review identified several needed research questions for the current study. One concerns the need for examining the complete cycle of economic change – a normal period, the economic downturn, and the economic recovery. Wu et al. 2002 divided time into only two periods, decline and recovery. This merges content prior to the downturn and the downturn itself – content which is likely to be quite different in tone as well as possible impact. It would be better to separate out the three time periods – prior, during, and after the economic downturn, and then examine media impacts during each time period. This approach would also make it possible to examine second-level agenda-setting effects—the relationship between tones and impact across three time periods. Stevenson et al. (1994) found that at one time period, public opinion affected mass media coverage, while at the next, mass media coverage affected public opinion. The use of Granger causality analysis can help separate out the relative influences of mass media, the real state of the economy, and public opinion across time intervals.

Since there is a need for study of a complete cycle, the current ongoing recession could not be selected for analysis because it is still in the early recovery phase. Instead, the last significant economic downturn was selected.

**Research Questions and Theoretical Models**

Based on the foregoing literature review, this study asks:

RQ1: Does economic news have significant impacts on consumer confidence before, during and after recessions?

RQ2: Does the real state of the economy predict consumer confidence significantly before, during and after recessions?

RQ3: In general, is economic news a better predictor of consumer confidence than the real state of the economy?

Based on the research questions shown above, the possible relationships among economic news, public perceptions and the real state of the economy are illustrated by the models shown below. The first model in Figure 1 suggests that the real state of the economy has much more powerful corresponding influence on public perceptions than economic news does. The second model in Figure 2 provides an
alternative suggestion that economic news have a more powerful corresponding impact on public perceptions than the real state of the economy does.

**Figure 1**
Model 1 of the Relationships among Economic News, Consumer Confidence and the Real State of the Economy

![Model 1](image1)

**Figure 2**
Model 2 of the Relationships among Economic News, Consumer Confidence and the Real State of the Economy

![Model 2](image2)

**METHOD**

This study focuses on the following three variables: 1). Economic News. 2). Consumer confidence; 3). The real state of the economy. The time frame selected by this study is from January 1997 to December 2006, which contains the 2001 recession and both the normal times before and after the recession. The first step was to find out the cut points of the different economic circumstances in the ten years. Wu et al. (2002) divided the whole period from 1987 to 1996 into two time frames, but the period from 1987 to 1991 includes not only the recession but also the 43 month upturn section. Moreover, researchers could merely observe the differences between one downturn period and one upturn period and couldn’t find out if there are also some differences between the upturn period before the recession and the recovery period after the recession. In order to eliminate these shortages, this study divides the whole period into three sections: the period around the recent recession, the following recovery period and the expansion period before the recession. According to the National Bureau of Economic Research (NBER, 2008), the 2001 recession began in March 2001 and ended in November 2001. Moreover, real personal
income fell in early 2001. It reached its low point in October 2001 and then generally rose throughout 2003, reaching its highest level in July 2003. Employment reached a peak in February 2001 and declined through July 2002. It rose slightly through November 2002, but with the exception of January 2003, declined throughout 2003 until it rose in September 2003. Gross Domestic Product (GDP) reached a peak in the fourth quarter of 2000. This was followed by contraction during the first three quarters of 2001 and growth since then. Based on these data, this study chose the period from January 2001 to December 2003 (36 months) to explore if media has greater impact on public opinion during recessions or times of economic slowdowns. It left two separated upturn periods of the economy, which are normal states of the economy: one is from January 1997 to December 2000 (48 months); the other is from January 2004 to December 2006 (36 months).

Data

To ensure that the samples that would be examined discuss the U.S. economy over time in a uniform way, a special U.S. Economy Section of *Business Week*, a leading publication that deals with business and economic issues, was selected. A preliminary search for the target articles from 1997 to 2006 using the search engine Business Source Elite generated a total of 500 headlines from 120 months. A total of 150 headlines were included in the period of economic slowdowns from January 2001 to December 2003. A total of 200 headlines were included in the period of normal state of the economy from January 1997 to December 2000. A total of 150 headlines were included in the period from January 2004 to December 2006.

Compared to lead paragraphs and full texts, headlines can be used to roughly estimate the broad contours of news coverage and usually adequately represent original content when researchers are working at a high level of aggregation (Althaus, Edy, & Phanlen, 2001). Many researchers believe that headlines are able to impact readers powerfully (Blood & Philips, 1995). Moreover, it is more difficult to achieve reliability with whole text than with headlines when coding. In the whole text of the U.S. Economy section in *Business Week*, authors usually shift tones several times, but the tone of headlines is clearer, which may help to achieve acceptable reliability. Therefore, this study uses headlines’ monthly averages as units of analysis. Using content analysis, this study focuses on the headlines in the special section from January 1997 to December 2006. A ten year time frame was chosen for two reasons. First, a ten year period was needed in order to include a complete business cycle. From 1997 to 2006, the U.S. economy experienced good years during 1997 to 1999, a recession period around 2001, and a recovery process after 2002. Second, this study used time series analysis and multivariate analysis, which requires large samples than do univariate studies. Since this study is based on monthly data analysis, 10 years, 120 months, is a good sample size.

The tone of headlines of the U.S. Economy section in *Business Week* refers to the general orientation of the headlines with respect to some economic topic or issue or with reference to the condition of the economy in general. In this study, there are three potential tones each headline might exhibit: 1). Positive (coded 1) means that the headline sees the economy as growing, and generally portrays optimism about the economic potential. These headlines contain positive phrases, adjectives or adverbs such as “a strong job market,” “good profit,” and “solid support.” Terms such as “low unemployment,” “high consumer spending,” and “high industrial output” will also be considered as positive signals. 2). Neutral (coded 0) means that the headline evaluates the current state of the economy as maintaining its previous position. Headlines that demonstrate the absence of positive or negative comments about the economy (or some aspects of it) also fell under this category. If positive and negative were mixed together in a headline without a clear interpretation of whether the economy was in good or bad shape, the headline was coded as neutral. 3). Negative (coded -1) means that the headline sees the economy as slowing down or declining. Reports that deal with setbacks and other conditions that may dampen economic activity also received this code. Negative phrases or terms such as “unemployment is getting worse,” “highest jobless rate,” and “dismal start” fell under the negative category. Since the CCI
is issued monthly, the coded headlines in Business Week were grouped on a monthly basis. To do this, coders coded each headline, and the monthly total scores were averaged.

To enhance intercoder reliability, coders received copies of the codebook containing the category definitions, coding guides and examples. Two coders conducted the intercoder reliability test to code 50 headlines of Business Week and obtained an acceptable kappa coefficient (K=0.727, p<0.001). Kappa coefficient is a statistical measure of inter-rater agreement. It is generally thought to be a more robust measure than simple percent agreement calculation since κ takes into account the agreement occurring by chance (Cohen, 1960).

The variable public perceptions are embodied in one consumer sentiment survey conducted by the Conference Board Consumer Research Center, an independent economic research organization. It is widely known as the Index of Consumer Confidence or CCI, which is considered to be a principal indicator of how people feel about the United States economy. Data about the Index of Consumer Confidence (CCI) from January 1997 to December 2006 were obtained from the website of PollingReport.com (2007), an independent, nonpartisan resource of trends of American public opinion.

The real state of the economy, depicted in business cycles, is depicted by a broad range of economic indicators such as employment, industrial output, GDP and consumption. This study uses the Standard & Poor’s 500 (S&P 500, 2008) to represent the real state of the economy. Standard & Poor’s U.S. indices are designed to reflect the U.S. equity markets and, through the markets, the U.S. economy. Widely regarded as the best single gauge of the U.S. equities market, this world-renowned index includes a representative sample of 500 leading companies in leading industries of the U.S. economy. It is considered to be a bellwether for the U.S. economy. The data of the S&P 500 from January 1997 to December 2006 were obtained from the website of the Standard & Poor’s. Figure 4 shows the plots of the time series of the three variables together.

**Figure 4**
The Standardized Data Plots of the Tone of Business Week, the CCI and the S&P 500 from 1997 to 2006

**Granger Causal Analysis**
Recently, for agenda setting over time, researchers concluded that simple cross-lagged analysis is seriously flawed since it only measures the relationship of media agenda and public agenda at two time
periods. When historical effects are presumed, the cross-lagged relationship of media agenda and public agenda should be measured at more than two time periods (Gonzenbach, 1996). The over time causality in longitudinal data can be determined by the Granger causal analysis.

A variable X is a “Granger cause” of a variable Y if Y is better predicted by the past histories of both X and Y rather than by the past histories of Y alone. Below are causal relationships that are examined through the Granger causal analysis.

1) An instantaneous causal link occurs when the present and the past history of one time series increase the other’s total variance explained.

2) A one-way causal relationship occurs if one time series explains the other, but the latter one does not explain the former one when both the two time series are included in regression equations in which each is dependent.

3) A feedback or reciprocal causal relationship occurs when two time series contribute equally to explain each other’s variance.

Finally, the absence of Granger causality is determined when neither of two series contributes to increase the other’s variance explained by including their past histories for the other (Smith, 1987; Freeman, 1983; Rogers, Dearing, & Chang, 1991).

Before testing Granger causality between any two time series, the contribution of each time series’ past histories upon itself must be determined. Thus, the univariate analysis of each time series is the first step of Granger causal analysis. This study applied ARIMA analysis to model each time series. The second step of Granger causal analysis is to conduct bivariate analysis of the relationships between each of the time series pair based on the determined ARIMA components of each time series.

Akaike information criterion (AIC), one of model selection criteria based on residuals, is used with other diagnostics of residuals, to check whether the ARIMA term in a given time series is a best model, which removes the systematic or the deterministic component of the series, leaving behind only the stochastic component (Wei, 1990).

**RESULTS**

**ARIMA Model Analysis**

The first parameter to a model is trend $d$, which is the motion or trend of a specific direction within a series – upward or downward – or any systematic change in the level of a time series (McCleary & Hay, 1980). In the identification stage, according to the plots of the three time series, this study found that all three time series showed a secular trend or cyclicality, or nonstationarity, which means that a systematic increase or decrease in a series distribution over time occurs, or $d=1$. Therefore, the three time series (tone of Business Week, the CCI, and the S&P 500) were first-order differenced to remove the linear trend from each one in order to apply the Box and Jenkins procedure which requires that all time series be stationary (Box & Jenkins, 1976). Through the Box and Jenkins procedure, the ARIMA components of each time series were determined. Table 1 shows the ARIMA terms for each time series and the total amount of variance explained by the ARIMA model of itself ($R^2$).

After taking the first order difference of the time series CCI and the S&P 500, this study selected trivial models or white noise as the models of the two time series. The AR(3) model was selected for the first-order differenced time series of the tone of *Business Week*.
Bivariate Analysis

In order to do bivariate analysis, transfer function models were constructed by adding the past histories of the independent series to the dependent series. Before constructing the transfer function models, a decision must be made about which lagged coefficients of the independent time series come to be included into the regression equations to explain the dependent series. This decision can be made based on the cross-lagged correlations between each two time series. A Pearson correlation test was conducted to calculate the cross-lagged correlations between the two time series of the tone of Business Week and the CCI at the T-0 point, the positive lags (i.e. with Business Week leading the CCI by 1, 2, 3, 4 and 5 months) and the negative lags (i.e. with the CCI leading Business Week by 1, 2, 3, 4 and 5 months), and the results are shown in Table 2 and Table 4. The cross-lagged correlations at the positive lags and those at the negative lags do not necessarily equal to each other (Smith, 1987; Freeman, 1983; Rogers, Dearing, & Chang, 1991). The same procedure of the Pearson correlation test and analysis were conducted between the time series of the S&P 500 and the CCI and between the time series of the S&P 500 and tone of Business Week. The results of the bivariate data analysis of the ten years, the 2001 recession and the two normal time periods around the recession are shown in Table 3 and Table 5. The lagged coefficients with statistically significant correlations in the correlogram were used to test the prediction series’ contribution to explaining the dependent series over time (Rogers, Dearing & Chang, 1991). The selected lagged coefficients in each time series are shown in Table 3 and Table 5.

Table 1
Univariate ARIMA Coefficients and Variance Explained for Each Time Series

<table>
<thead>
<tr>
<th>Time series</th>
<th>ARIMA term</th>
<th>Coefficients**</th>
<th>R²</th>
</tr>
</thead>
<tbody>
<tr>
<td>Tone of Business Week***</td>
<td>(3,1,0)</td>
<td>AR(3)=-.4914 * (.0897);</td>
<td>0.215*</td>
</tr>
<tr>
<td></td>
<td></td>
<td>-.2482* (0.0975);</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td>-.2008* (0.0891)</td>
<td></td>
</tr>
<tr>
<td>Tone of Business Week***</td>
<td>(3,1,0)</td>
<td>AR(3)=-.5066 * (.1417);</td>
<td>0.323*</td>
</tr>
<tr>
<td></td>
<td></td>
<td>-.0924* (0.1620);</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td>-.2151* (0.1471)</td>
<td></td>
</tr>
<tr>
<td>Tone of Business Week***</td>
<td>(3,1,0)</td>
<td>AR(3)=-.5301 * (.1692);</td>
<td>0.248 *</td>
</tr>
<tr>
<td></td>
<td></td>
<td>-.2085* (0.1902);</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td>-.0752* (0.1689)</td>
<td></td>
</tr>
<tr>
<td>Tone of Business Week***</td>
<td>(3,1,0)</td>
<td>AR(3)=-.3476 * (.1654);</td>
<td>0.203 *</td>
</tr>
<tr>
<td></td>
<td></td>
<td>-.4075* (0.1571);</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td>-.1784* (0.1608)</td>
<td></td>
</tr>
<tr>
<td>CCI***</td>
<td>(0,1,0)</td>
<td>0</td>
<td></td>
</tr>
<tr>
<td>S&amp;P 500***</td>
<td>(0,1,0)</td>
<td>0</td>
<td></td>
</tr>
</tbody>
</table>

* Indicates the coefficient is significant at p<.001.
** AR is autoregressive; MA is a moving average. The number in the parentheses following each AR or MA is the time lag in months. The number following each AR or MA term is the standard error of each coefficient of the ARIMA term.
*** These series are first order differenced.

Based on the analysis above, transfer function models of the dependent series were constructed. Transfer function analyses produce transfer function coefficients, which indicate the dynamic, cyclical relationships between each of the time series pairs and reveal the statistical significance of each predictor’s contribution and its direction in affecting the dependent series. Take the transfer function
analysis of the CCI and the tone of *Business Week* for example. The transfer function equations regarding the two variables are shown below (R-1 & R-2).

\[ C=2.417B_{t-1}+a_t \]  \hspace{1cm} (R-1)

Where \( C \) is the CCI*** and \( B \) is the tone of *Business Week***, \( a_t \) is an error, \( a_t \sim \text{nid}(0, 38.695) \).

\[ B= -.018C_{t-4}-.489B_{t-1}-.224B_{t-2}-.193B_{t-3}+a_t \]  \hspace{1cm} (R-2)

Where \( a_t \) is an error, \( a_t \sim \text{nid}(0, 1.643) \).

The reason for one coefficient is much less than the other one (i.e. 2.417 vs. -0.018) is that after taking the first order difference, the CCI and the tone of *Business Week* still have different ranges of variance (CCI: \([-18.0, 19.6]\); Business Week: \([-1.27, 1.10]\)).

### Table 2
Cross-lagged Correlations among the CCI, the S&P 500 and the Tone of *Business Week* from Time t-5 to Time t+5 (1997 – 2006)

<table>
<thead>
<tr>
<th>Variable at time ( t )</th>
<th>Lagged Variable</th>
<th>-5</th>
<th>-4</th>
<th>-3</th>
<th>-2</th>
<th>-1</th>
<th>0</th>
<th>1</th>
<th>2</th>
<th>3</th>
<th>4</th>
<th>5</th>
</tr>
</thead>
<tbody>
<tr>
<td>CCI***</td>
<td>S&amp;P500***</td>
<td>0.146</td>
<td>-</td>
<td>0.090</td>
<td>0.034</td>
<td>0.179**</td>
<td>0.324*</td>
<td>0.168*</td>
<td>0.028</td>
<td>-</td>
<td>0.017</td>
<td>0.139</td>
</tr>
<tr>
<td>CCI***</td>
<td>Business Week***</td>
<td>0.044</td>
<td>-</td>
<td>0.050</td>
<td>0.074</td>
<td>-0.118</td>
<td>0.205*</td>
<td>0.096</td>
<td>0.038</td>
<td>0.053</td>
<td>-</td>
<td>0.043</td>
</tr>
<tr>
<td>Business Week***</td>
<td>S&amp;P500***</td>
<td>-</td>
<td>-</td>
<td>0.062</td>
<td>0.024</td>
<td>-</td>
<td>0.004</td>
<td>0.095</td>
<td>-0.038</td>
<td>0.169*</td>
<td>-</td>
<td>0.090</td>
</tr>
</tbody>
</table>

* Significant at \( p<.05 \).
** Significant at \( p<.01 \).
*** These series are first order differenced.
Table 3
Transfer Function Coefficients, Total Variance ($R^2$) Explained, and Incremental Variance Due to the Predictors of the Independent Series (1997 - 2006)

| Dependent series (Y) | Independent series (X) | Transfer function coefficient | Standard error of coefficient | Total $R^2$ | Incremental $R^2$
<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>CCI***</td>
<td>Business Week***</td>
<td>2.417,1*</td>
<td>1.14</td>
<td>0.037</td>
<td>0.037*</td>
</tr>
<tr>
<td>Business Week***</td>
<td>CCI***</td>
<td>-.018,4**</td>
<td>0.007</td>
<td>0.264</td>
<td>0.049***</td>
</tr>
<tr>
<td>CCI***</td>
<td>S&amp;P 500***</td>
<td>0.025,*</td>
<td>0.011</td>
<td>0.181</td>
<td>0.181**</td>
</tr>
<tr>
<td></td>
<td></td>
<td>0.045,1**</td>
<td>0.011</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td>0.023,2*</td>
<td>0.011</td>
<td></td>
<td></td>
</tr>
<tr>
<td>S&amp;P 500***</td>
<td>CCI***</td>
<td>1.36,</td>
<td>0.715</td>
<td>0.3</td>
<td>0.3</td>
</tr>
<tr>
<td>Business Week***</td>
<td>S&amp;P 500***</td>
<td>0.001,</td>
<td>0.001</td>
<td>0.232</td>
<td>0.018</td>
</tr>
<tr>
<td>S&amp;P 500***</td>
<td>Business Week***</td>
<td>15.173,</td>
<td>8.981</td>
<td>0.024</td>
<td>0.024</td>
</tr>
</tbody>
</table>

* Significant at p<.05.
** Significant at p<.01.
*** These series are first order differenced.

Transfer function analyses also provide $R^2$, which is the proportion of the total variance of the dependent series explained by its past histories, the ARIMA component, plus the independent series. Estimates of the incremental variance solely explained by the prediction series over and above the dependent series itself can be made through subtracting the $R^2$ of the univariate ARIMA models from the $R^2$ of the transfer function models. The statistical significance of the incremental variance is determined by the F-test. The F-test for the incremental variance jointly tests the statistical significance of all the included predictors of the independent series in the transfer function analyses. For example, R-3 shows the reduced model of the dependent variable Y, and R-4 shows the complete model of Y.

\[
Y = Y_1 \quad \text{(R-3)}
\]

\[
Y = Y_1 + X_1 \quad \text{(R-4)}
\]

Where $Y_1$ is the past history of Y which can predict Y, $X_1$ is all the included predictors of the independent variable X which can predict Y. The incremental variance is the difference between the variance of Y explained by the complete model and that explained by the reduced model.
Table 4
Cross-lagged Correlations among the CCI, the S&P 500 and the Tone of Business Week from Time t-5 to Time t+5
N=120 Observations Lag Length (in months)

<table>
<thead>
<tr>
<th>Variable at time0</th>
<th>Lagged Variable</th>
<th>Time frame</th>
<th>-5</th>
<th>-4</th>
<th>-3</th>
<th>-2</th>
<th>-1</th>
<th>0</th>
<th>1</th>
<th>2</th>
<th>3</th>
<th>4</th>
<th>5</th>
</tr>
</thead>
<tbody>
<tr>
<td>CCI***</td>
<td>S&amp;P500***</td>
<td>1997-2000</td>
<td>0.286**</td>
<td>-0.180***</td>
<td>-0.157**</td>
<td>0.329**</td>
<td>0.338**</td>
<td>0.043**</td>
<td>0.056**</td>
<td>0.117**</td>
<td>0.338**</td>
<td>0.058**</td>
<td>-0.123**</td>
</tr>
<tr>
<td></td>
<td></td>
<td>2001-2003</td>
<td>0.080**</td>
<td>0.240**</td>
<td>0.080**</td>
<td>0.111**</td>
<td>0.537**</td>
<td>0.416**</td>
<td>0.054**</td>
<td>0.054**</td>
<td>0.240**</td>
<td>-0.174**</td>
<td>0.022**</td>
</tr>
<tr>
<td></td>
<td></td>
<td>2004-2006</td>
<td>0.014**</td>
<td>-0.130**</td>
<td>0.089**</td>
<td>-0.144**</td>
<td>0.257**</td>
<td>0.268**</td>
<td>0.124**</td>
<td>0.185**</td>
<td>0.173**</td>
<td>-0.211**</td>
<td>0.323**</td>
</tr>
<tr>
<td>CCI***</td>
<td>Business Week**</td>
<td>1997-2000</td>
<td>0.122**</td>
<td>0.122**</td>
<td>0.142**</td>
<td>-0.067**</td>
<td>0.181**</td>
<td>0.200**</td>
<td>0.205**</td>
<td>0.030**</td>
<td>0.132**</td>
<td>-0.327**</td>
<td>0.078**</td>
</tr>
<tr>
<td></td>
<td></td>
<td>2001-2003</td>
<td>-0.048**</td>
<td>-0.270**</td>
<td>0.109**</td>
<td>-0.18**</td>
<td>0.467**</td>
<td>0.052**</td>
<td>0.004**</td>
<td>0.145**</td>
<td>0.045**</td>
<td>-0.042**</td>
<td>-0.316**</td>
</tr>
<tr>
<td></td>
<td></td>
<td>2004-2006</td>
<td>0.000**</td>
<td>0.207**</td>
<td>0.031**</td>
<td>0.205**</td>
<td>-0.044**</td>
<td>0.426**</td>
<td>0.038**</td>
<td>0.025**</td>
<td>0.212**</td>
<td>-0.219**</td>
<td>-0.079**</td>
</tr>
<tr>
<td>Business Week**</td>
<td>S&amp;P500***</td>
<td>1997-2000</td>
<td>0.045**</td>
<td>-0.058**</td>
<td>0.017**</td>
<td>0.255**</td>
<td>-0.194**</td>
<td>0.182**</td>
<td>0.205**</td>
<td>0.294**</td>
<td>0.111**</td>
<td>0.227**</td>
<td>0.119**</td>
</tr>
<tr>
<td></td>
<td></td>
<td>2001-2003</td>
<td>-0.131**</td>
<td>0.099**</td>
<td>0.038**</td>
<td>0.116**</td>
<td>-0.074**</td>
<td>0.377**</td>
<td>0.121**</td>
<td>0.031**</td>
<td>0.070**</td>
<td>0.445**</td>
<td>0.131**</td>
</tr>
<tr>
<td></td>
<td></td>
<td>2004-2006</td>
<td>0.085**</td>
<td>-0.083**</td>
<td>0.039**</td>
<td>0.014**</td>
<td>0.413**</td>
<td>0.056**</td>
<td>0.145**</td>
<td>0.015**</td>
<td>0.015**</td>
<td>-0.180**</td>
<td>0.075**</td>
</tr>
</tbody>
</table>

* Significant at p<.05.
** Significant at p<.01.
*** These series are first order differenced.

Table 3 shows the results of four transfer function analyses for each of the time series pair. The results indicate that the tone of Business Week is one of the causes of the CCI in terms of Granger causality in general. As was shown in Table 3, the economic reporting by media in one specific month can statistically explain 3.7 percent of the variance in the following month’s CCI. That is, the tone of Business Week in one month can predict the CCI in the following month. The Granger causality also presents in the reverse direction, which means the CCI can be a predictor of the tone of Business Week, since the CCI can explain 4.9 percent of variance of the tone of Business Week. However, that prediction is based upon a four-month lag in time, while the one, two and three-month lags failed to significantly predict Business Week. This suggests that this result might be spurious. Second, the S&P 500 is a statistically significant predictor of the CCI. According to Table 3, the S&P 500 (at lags 0, 1 and 2) explain 18.1 percent of variance of the CCI. However, the CCI cannot be a predictor of the S&P 500 since the CCI can explain only 3 percent of variance of the CCI with no statistical significance. Third, the Granger causality is absent between the S&P 500 and the tone of Business Week.

Based on the significant correlations shown in Table 4, a transfer function analysis was conducted. The results shown in Table 5 indicate that from January 2001 to December 2003, times of the recession and economic slowdowns, the tone of Business Week (at lag 1) can explain 19.8 percent of variance of the CCI; From January 2004 to December 2006, after the recession and economic slowdowns, the tone of Business Week (at lag 0) can explain 16.2 percent of the variance of the CCI. These results indicate that
the tone of *Business Week* has a positive effect on the CCI during and after the recession but doesn’t have any effect on the CCI before the recession.

Table 5
Transfer Function Coefficients, Total Variance ($R^2$) Explained, and Incremental Variance Due to the Predictors of the Independent Series (1997 - 2000)

<table>
<thead>
<tr>
<th>Dependent series (Y)</th>
<th>Independent series (X)</th>
<th>Time frame</th>
<th>Transfer function coefficient</th>
<th>Standard error of coefficient</th>
<th>Total $R^2$</th>
<th>Incremental $R^2$</th>
</tr>
</thead>
<tbody>
<tr>
<td>CCI***</td>
<td><em>Business Week</em>**</td>
<td>1997-2000</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td></td>
<td></td>
<td>2001-2003</td>
<td>6.759**</td>
<td>2.404</td>
<td>0.198**</td>
<td>0.198**</td>
</tr>
<tr>
<td></td>
<td></td>
<td>2004-2006</td>
<td>4.589*</td>
<td>1.813</td>
<td>0.162</td>
<td>0.162*</td>
</tr>
<tr>
<td><em>Business Week</em>**</td>
<td>CCI***</td>
<td>1997-2000</td>
<td>-0.023***</td>
<td>0.013</td>
<td>0.372</td>
<td>0.049</td>
</tr>
<tr>
<td></td>
<td></td>
<td>2001-2003</td>
<td>-0.025***</td>
<td>0.011</td>
<td>0.353*</td>
<td>0.145*</td>
</tr>
<tr>
<td></td>
<td></td>
<td>2004-2006</td>
<td>-0.030*</td>
<td>0.015</td>
<td>0.307</td>
<td>0.104</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>0.033***</td>
</tr>
<tr>
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<td>0.010</td>
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<td>0.382</td>
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<td>0.382**</td>
</tr>
<tr>
<td>CCI***</td>
<td>S&amp;P 500***</td>
<td>1997-2000</td>
<td>0.032***</td>
<td>0.010</td>
<td>0.027***</td>
<td>0.010</td>
</tr>
<tr>
<td></td>
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<td>2001-2003</td>
<td>0.033</td>
<td>0.024</td>
<td>0.247*</td>
<td>0.247*</td>
</tr>
<tr>
<td></td>
<td></td>
<td>2004-2006</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td></td>
<td></td>
<td>1997-2000</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td></td>
<td></td>
<td>2001-2003</td>
<td>2.103</td>
<td>1.158</td>
<td>0.091</td>
<td>0.091</td>
</tr>
<tr>
<td></td>
<td></td>
<td>2004-2006</td>
<td>1.330</td>
<td>0.737</td>
<td>0.353</td>
<td>0.145*</td>
</tr>
<tr>
<td>S&amp;P 500***</td>
<td>CCI***</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>0.358</td>
</tr>
<tr>
<td></td>
<td></td>
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<td></td>
<td></td>
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<td>0.033***</td>
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<td>0.010</td>
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<td></td>
<td></td>
<td>0.382</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>0.382**</td>
</tr>
<tr>
<td><em>Business Week</em>**</td>
<td>S&amp;P 500***</td>
<td>1997-2000</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td></td>
<td></td>
<td>2001-2003</td>
<td>0.004*</td>
<td>0.002</td>
<td>0.347*</td>
<td>0.102*</td>
</tr>
<tr>
<td></td>
<td></td>
<td>2004-2006</td>
<td>0.009**</td>
<td>0.003</td>
<td>0.382</td>
<td>0.179**</td>
</tr>
<tr>
<td>S&amp;P 500***</td>
<td><em>Business Week</em>**</td>
<td>1997-2000</td>
<td>35.047</td>
<td>17.885</td>
<td>0.082</td>
<td>0.082</td>
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<tr>
<td></td>
<td></td>
<td>2001-2003</td>
<td>29.190</td>
<td>15.394</td>
<td>0.287**</td>
<td>0.287**</td>
</tr>
<tr>
<td></td>
<td></td>
<td>2004-2006</td>
<td>-35.887*</td>
<td>15.5</td>
<td>-</td>
<td>-</td>
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</tbody>
</table>

* Significant at p<.05.
** Significant at p<.01.
*** These series are first order differenced.

From 1997 to 2000, S&P 500 (at lags 1, 2 and 5) can explain 38.2 percent of variance of the CCI. This figure declined to 24.7 percent from 2001 to 2003. Therefore, before the recession, S&P 500 has more powerful effect on the CCI than the tone of *Business Week* does; during the recession and times of economic slowdowns, both S&P 500 and the tone of *Business Week* have almost similar powerful effect on the CCI.
From 2001 to 2003, the S&P 500 can explain 10.2 percent of variance of the tone of *Business Week*. From 2004 to 2006, the figure was increased to 17.9 percent. That means during and after the recession, the S&P 500 can predict the tone of *Business Week* significantly.

There are some other pairs of variable showed significant relationships according to the results in Table 5, but the impacts from the lag 4 or the lag 5 of these independent variables are suspicious.

**Multivariate Analysis**

The multivariate analysis was conducted to compare the relationships among the three variables during the whole ten years. The S&P 500 at time 0, time -1 and time -2, and the tone of *Business Week* at time -1 were chosen as predictors since they have significant correlations with the CCI at time 0. The reduced model predicting the CCI over time is shown below (R-5).

\[
C_t = 0.027S_t + 0.042S_{t-1} + 0.024S_{t-2} + 2.153B_{t-1} + a_t \quad \text{(R-5)}
\]

Where C is the CCI***, S is the S&P 500***, and B is the tone of *Business Week***, \(a_t\) is an error, \(a_t \sim \text{nid}(0, 31.391)\).

<table>
<thead>
<tr>
<th>Independent series</th>
<th>Transfer function coefficient</th>
<th>Standard error of coefficient</th>
<th>Total R²</th>
<th>Incremental R²</th>
</tr>
</thead>
<tbody>
<tr>
<td>1 S&amp;P 500***</td>
<td>0.027,*</td>
<td>0.011</td>
<td>0.209*</td>
<td>0.172**</td>
</tr>
<tr>
<td></td>
<td>0.042, **</td>
<td>0.011</td>
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<td></td>
</tr>
<tr>
<td></td>
<td>0.024, *</td>
<td>0.011</td>
<td></td>
<td></td>
</tr>
<tr>
<td>2 Business Week***</td>
<td>2.153t-1,*</td>
<td>1.074</td>
<td>0.209*</td>
<td>0.028*</td>
</tr>
</tbody>
</table>

Table 6 shows the results of the analysis based on the reduced model (R-5), which indicates that the tone of *Business Week* explains only 2.8% of variance of the CCI, and the percentage of the variance of
the CCI significantly explained by the S&P 500 (17.2%) is much greater than that explained by the tone of Business Week, which means the S&P 500 is a better predictor of the CCI than the tone of Business Week is. These results are very close to the results of the bivariate analysis shown above.

Table 7 presents the results of the multivariate analysis of the data from January 2001 to December 2003 based on the reduced model as below.

\[ C_t = 0.044S_t + 0.041S_{t-1} + 6.011B_{t-1} + a_t \]  

(R-6)

Where C is the CCI**, S is S&P 500***, and B is tone of Business Week***, \( a_t \) is an error, \( a_t \sim \text{nid}(0, 21.950) \).

The results show that the 18.5 percent of variance of the CCI is explained by the S&P 500, and 13.6 percent of variance of the CCI is explained by the tone of Business Week. Since there is no correlation between the CCI and the tone of Business Week in the two upturn periods of the economy, the period from 1997 to 2000 and the period from 2004 to 2006, there is no need to do multivariate analysis for the data of the two time periods.

**CONCLUSION AND DISCUSSION**

The results indicated that 1) from 1997 to 2006, the first model shown in Figure 1 is supported, which suggested that economic news has limited effects on consumer confidence, and the real state of the economy actually predicts consumer confidence on a large scale; 2) during the expansion period from 1997 to 2000, economic news has no impact on consumer confidence; 3) during the 2001 recessions, both economic news and the real state of the economy have significant effects on consumer confidence; 4) during the following recovery period from 2004 to 2006, the second model shown in Figure 2 is supported, which suggests economic news have a more powerful corresponding impact on consumer confidence than the real state of the economy does. The results also show that economic news tends to more accurately reflect the real state of the economy during and after the recession, and the real state of the economy didn’t influence economic news before the recession.

The observations partially echo the research of Wu et al. that the level of impacts of economic news on public perceptions depends on different economic circumstances, and that individuals pay greater attention to economic news during recessions and times of economic slowdowns (Blood & Phillips, 1995).

As mentioned above, this study divided the ten year time frame into three sections, the upturn period before the recession, the recession and times of economic slowdowns and the recovery time after the recession, instead of two time sections as Wu et al (2002) divided. Therefore, this study had a chance to look at the differences of the effects between the normal times before and after the recession. And what this study found is that the agenda setting effect was absent during the normal time before the recession, while it was strong during the normal time after the recession. Moreover, the level of effects of economic news after the recession is only slightly less than that during the recession. The observations imply that other than the different economic circumstances, there are more explanations of the different results of the two normal times. A good reason to clarify the complex results is that media could have conditional agenda setting effect.

With the 2001 recession, the 9/11 in 2001, the Iraq war began in 2003, the Katrina Hurricane in 2005 and the dramatically increasing gasoline prices in 2006, economic news tend to be negatively framed and tend to be covered more frequently. Consumers update their expectations about the economy much more frequently during periods of high news coverage than during periods of low news coverage, while high news coverage of the economy is often experienced during and immediately after recessions (Doms &
Morin, 2004). In addition, as previous studies suggested, negatively framed news coverage of the economy is a better predictor of corresponding attitudes toward future economic conditions than positively framed news coverage (Alsem, et al., 1994; Goidel & Langley, 1995). Therefore, an audience-contingent model proposed by Erbring, Goldenberg and Miller (1980) may provide a good explanation to the results under different economic conditions.

“Media effect” is usually defined as a mirror-image relation between the agenda of media and the agenda of the public audience. However, sources such as people's experiences, group perspective and real-world conditions as long as media exposure may all impact on individual’s concern. Thus, it is unwarranted to conclude that any increase or decrease in media coverage would trigger a corresponding increase or decrease in individual concern. The audience-contingent effect model describes processes over time and thus would be an appropriate model for longitudinal design. The audience-contingent effect model assumes that media coverage interacts with audience’s pre-existing sensitivities to produce changes in public concern. This finding indicates that audience doesn’t always reflect what media tell them.

Thus, media effect in the present study cannot be explained by a mirror-image relationship. Instead, the findings support the argument that audience sensitivities to issues and moods of media depending on their real world’s economic circumstances are modulators of media’s second-level agenda-setting effects. This explanation improves the initial finding of audience-contingent model into second-level agenda setting effects.

In addition, obstacles to agenda setting suggested by Wanta & Mahmoud (1990) also can explain why the agenda-setting effect was absent from 1997 to 2000. There are situations in which the media agenda may not influence the audience agenda, which suggests that this study may find out economic reporting has no effect on the CCI. For example, around 1997 to 2000, the Asian Financial Crisis added stresses on the global economy. This oversea event might draw the public attention and interfere with the agenda-setting process. Another example is that some issues such as high tech are considered as “pet” issues, which public may consider the nation’s most important problems, and therefore consumers paid more attention to these issues and ignored other important issues of the economy.

Overall, the audience-contingent effect model got stronger supported by the results of this study. Consumers’ experiences of the economy, real conditions of the economy and individuals’ exposures to economic news influence on individuals’ processing of economic news. Consumers’ sensitivities to economic news and its moods under different economic conditions modulate impacts of economic news toward individuals. During the upturn period before the recession, consumers could pay less attention to economic news, and therefore their perceptions toward the economy mostly shaped by the real state of the economy and other factors and weren’t influenced by economic news. During the recession, consumers pay greater attention to economic news, and their attitudes toward the economy are partially shaped by the real state of the economy and other factors, and economic news as well. After the recession and in the bad mood of the real world, consumer sensitivities to economic issues and their moods remained still and influenced consumers processing economic news.

There are several options for further studies. First, since this study only looked at Business Week headlines, which is a possible weakness. Future studies can analyze the tone of the U.S. economy section in Business Week and other business publications through whole articles to see if different conclusions would be drawn. Second, future studies can also explore effects of media other than print media to see if there are more powerful effects on public perceptions toward the economy from electronic media, or from interpersonal communications. Third, researchers can also examine more than one business cycle and compare whether there are consistent results in different time frames.
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DESIGN AND PRICING OF PROBABILISTIC QUALITY

Zelin Zhang, Ph. D. Candidate, School of Business, University of Kansas

ABSTRACT

Increasingly, services marketers are employing a new basis for market segmentation: probabilistic quality. In this segmentation scheme, one segment is offered a certain, high-quality product whereas a second segment is offered a product with probabilistic quality wherein quality may be either high or low. Given this emerging practice, we develop a model that demonstrates the profit opportunity associated with probabilistic quality. We seek to answer the following managerially relevant questions: (i) How is segmentation via probabilistic quality implemented? In particular, how are quality levels and prices determined? Moreover, should firms offer only probabilistic quality (“degraded” strategy) or should they offer both the certain product as well as the probabilistic product (“tiered” strategy)? (ii) When a firm has a choice of market segments to offer the probabilistic product, which segment is more attractive? (iii) How is the implementation of probabilistic quality impacted when the choice of capacity is made endogenous?

INTRODUCTION

Consider the following observed marketing practices. An internet broadband service provider offers two levels of service: Gold and Palladium. The Gold service is priced at $59.95 and offers guaranteed download speed of 50Mbs. The Palladium service, on the other hand, is priced lower at $49.95 but the download speed is variable. Next, a racquet club offers two levels of pricing for court time: a higher rate for guaranteed court availability and a lower rate which provides court time as capacity becomes available. Similarly, a hotel offers a premium suite with two levels of pricing: a higher rate for guaranteed availability and an implicitly lower rate for members of its loyalty program but subject to availability. Finally, a major theme park offers two types of tickets: a higher-priced ticket that allows patrons to join a line with substantially reduced waiting times and a lower-priced offering that is restricted to the regular line.

Of course, these examples are but an application of the robust marketing concept of segmentation. What is new is the basis of segmentation: probabilistic quality. In all of these examples, one segment is offered a certain, high-quality product. A second segment is offered a product with probabilistic quality wherein quality may be either high or low. Specifically, customers in this second segment sometimes receive the same quality as that offered to customers in the first segment. At other times, they receive a lower level of quality. So, in the case of internet service, customers with the Palladium level of service may sometimes enjoy the same download speed as customers with the Gold service. At other times, they receive service with lower levels of download speeds. Similarly, in the case of the hotel, customers in the loyalty program may sometimes enjoy the premium suite. At other times, they do not enjoy this upgrade and have to be content with the standard offering.

We observe that market segmentation employing probabilistic quality is likely to be most germane for service marketers. This is because the implementation of probabilistic quality requires that customers are limited in their ability to arbitrage products. In the case of physical goods, customers (or entrepreneurial middleman) can always re-market the products and thereby undo the segmentation schemes of the marketer. Such arbitrage is relatively difficult in the case of services because consumption requires the presence of the customer. Moreover, as suggested in Shugan and Xie (2004), the use of electronic smart cards embedded with bio-metric identification devices further limits service delivery to the purchaser, further constraining such after-market trades.
Given the growth of service industries in the world economy, it is likely that the importance of segmentation schemes based on probabilistic quality will only increase. These observations provide us with the motivation to formally examine the design and pricing of probabilistic quality. Thus, we develop an analytical model that highlights the profit opportunity associated with segmenting on the basis of probabilistic quality. We seek to answer the following managerially relevant questions: (i) How is segmentation via probabilistic quality implemented? In particular, how are prices and quality levels determined? Moreover, should firms offer only probabilistic quality (degraded strategy) or should they follow a mixed strategy that includes both the certain product as well as the probabilistic product (hybrid strategy)? (ii) When a firm has a choice of market segments to offer the probabilistic product, which segment is more attractive? (iii) How is the implementation of probabilistic quality impacted when the choice of capacity is made endogenous?

The rest of the paper is organized in the following manner. In the next section, we briefly review the background literature. Then, we present our model, analysis, and findings. Finally, we conclude with a discussion of the key implications associated with our findings.

**LITERATURE REVIEW**

There is a growing body of research in the marketing literature that analyses probabilistic aspects of market exchanges. An important initial contribution that includes the probabilistic aspects of market exchanges is Shugan and Xie (2000). These researchers analyze the profitability from advance selling when buyers know their willingness to pay only with some probability. Specifically, buyers assign some probability to the event that they will possess a high willingness to pay at the future date of consumption. In this context, the seller has to design a pricing scheme that will maximize profits and has the possibility of selling the service in the period before consumption (advance period). The key result is that when customers are homogeneous in the advance period but heterogeneous in the consumption period, advance selling can extract as much consumer surplus as first-degree price discrimination.

An important evolution of this line of thinking is Fay and Xie (2004), who introduce the notion of probability on the seller side. Specifically, in addition two fixed goods, the seller offers a probabilistic good which essentially consists of a lottery between the two fixed goods. In their model, a key benefit of such a probabilistic selling scheme is enhanced price discrimination between buyers who have polarized tastes and those that are relatively indifferent between the two products. Moreover, for those sellers facing unfilled demand conditions, probabilistic selling also offers the valuable benefit of market expansion. Finally, when sellers face demand uncertainty, probabilistic selling can further enhance profits because it removes the information disadvantage of the seller.

Biyalogorsky and Gerstner (2004) analyze a model in which buyers appear at different times, with the possibility of a high-valuation customer arriving in the second period. They then introduce the possibility of a contingent contract which essentially amounts to keeping the first-period customer while the seller resolves the uncertainty about the arrival of the high-valuation customer in the second period. If the high-valuation customer does arrive, the seller pays the first-period customer a consolation reward; otherwise, the first-period customer gets the product. Biyalogorsky and Gerstner (2004) derive the optimal contingent contract as a function of buyer risk-aversion and also demonstrate the conditions where it enhances seller profits. They also discuss the economic efficiency associated with this emerging pricing practice.

Our analysis is very similar to the work of Fay and Xie (2004) in that it also involves a probabilistic good. However, our probabilities occur over different quality levels whereas their probabilities occur over horizontally differentiated product. Moreover, the number of customers targeted is intimately linked to the quality provided by the seller and we provide new insights on the design and pricing of such probabilistic products. We also examine how a firm facing a choice in segments with respect to the
probabilistic product may optimally choose its target segment. It is in this manner that our research builds on the work of Fay and Xie (2008).

Our analysis is also very similar to Fay and Xie (2008) and Biyalogorsky and Gerstner (2004) in that it characterizes an emerging pricing practice. As described in Fay and Xie (2008), we believe that emerging technologies will only facilitate many types of probabilistic selling. For instance, smart-card technologies will reduce the possibility of arbitrage among consumers. In addition, new channel intermediaries may emerge who will independently verify the probabilities announced by the seller. We next describe our model and analysis.

MODEL AND ANALYSIS

Here, we begin by describing the key elements of our model. We then present our analysis that responds to the questions that we seek to address in our research endeavor.

Model

Our model setting consists of a monopoly seller designing and pricing a service. The market consists of two segments, H and L. Segment H consists of customers willing to pay a relatively high level for the service. Segment L consists of customers who are willing to pay a relatively low level for the service. We set these valuations as $V_H$ and $V_L$, with $V_H > V_L$.

Of course, all customers experience a decrease in utility if quality is offered only with some probability. To focus on the main issues, we assume that the low level of quality associated with the product is valued equally by all segments and is therefore offered at the same price to all. Without loss of generality, we set this basic level of quality, and its price, to zero. Thus, in the case of probabilistic quality, the uncertainty is whether or not the customer will receive the additional element of quality. It is this additional element of quality for which the valuations are $V_H$ and $V_L$, as described previously. Denoting the probability of receiving the high quality product as $\phi$ and its prices as $p$, we next specify the utility enjoyed by customers in the two segments as:

\begin{align*}
U_H &= V_H - s_H (1 - \phi)^2 - p \quad (1a) \\
U_L &= V_L - s_L (1 - \phi)^2 - p \quad (1b)
\end{align*}

Equations (1a) and (1b) reveal that the utility is decreased by the probability of not receiving the additional element of quality. In straightforward fashion, we expect the utility to be degraded in convex fashion in the probability of not receiving quality. Further, we choose the quadratic form for analytical convenience. In addition, the degradation in utility is scaled by a distaste parameter, $s$. We further assume that the customers in the H segment have a high disutility from not receiving quality. In other words, they are characterized by a high value for the distaste parameter, $s_H$. Again, to focus on the main issues, we set $s_H$ to be very large; thus, the seller will always offer certain quality when targeting customers in segment H. This mirrors the practice described in the opening vignettes where one segment receives the high quality with certainty. Given this simplification, we also drop the subscript on $s_L$ and simply refer to it as $s$.

We also assume that capacity for quality is fixed at $M$ and the number of high type customers in the market is $n_H$, with $M > n_H$. That is, there is more capacity for quality than the number of people willing to consume quality. (This suggests one of our research questions: If choice of capacity is a decision variable, will the seller choose $M > n_H$? This is a question that we do indeed pursue in our analysis). In our notation, the number of segment H customers that the seller chooses to serve is $n_H$ and the number of segment L customers that the seller chooses to serve is $n_L$. Finally, we assume that there is no limit on the
number of customers that belong to segment L in the market. Please see Figure 1 for a pictorial depiction of seller capacity and size of the segments in the market.

Figure 1: Capacity and Segment Sizes

Capacity for Quality, $M$

$n_c$: Number of segment H customers

Very large pool of segment L customers

Basic Analysis

We begin our analysis by considering a structure wherein the seller offers the certain product to customers in segment H and a probabilistic product to customers in segment L. Obviously, if served, the price for H customers is always set to $V_H$ - the seller extracts the full surplus from customers in the segment. Thus, the goal in the analysis is to derive the number of customers to target in segments H and L, $n_H$ and $n_L$, as well as the parameters of the probabilistic good: the probability of receiving high quality, $\phi$, and its price, $p$.

The utility of customers in segment L upon purchasing the probabilistic product is given as:

$$U_L = V_L - s \left(1 - \frac{M - n_H}{n_L}\right)^2 - p, \quad s > V_L$$

(2)

The term, $\frac{M - n_H}{n_L}$ in equation (2) is the probability that a customer in segment L will receive high quality, $\phi$. It follows from the fact that there is a total capacity of $M$ and $n_H$ customers from segment H receive high quality; thus, $n_L$ customers vie for $(M - n_H)$ capacity. In addition, $s > V_L$ within our model setting else customers will receive positive utility even when the probability of receiving quality, $\phi$, is zero.

In this scenario, profits to the firm are written as:

$$\Pi = n_H V_H + n_L p$$

$$= n_H V_H + n_L V_L - n_L s \left(1 - \frac{M - n_H}{n_L}\right)^2$$

(3)
The seller’s objective is to choose \( n_H \) and \( n_L \) in order to maximize its profits. Formally:

\[
\begin{align*}
\text{Max} & \quad \prod = n_H V_H + n_L V_L - n_L s \left( 1 - \frac{M - n_H}{n_L} \right)^2 \\
\text{Subject to} & \quad M \geq n_H; \\
& \quad 0 \leq n_H \leq n_0. 
\end{align*}
\]

The first-order conditions associated with this maximization problem are as follows:

\[
\begin{align*}
\frac{\partial \prod}{\partial n_H} &= V_H - 2n_L s \left( 1 - \frac{M - n_H}{n_L} \right) \frac{1}{n_L} = 0 \\
\Rightarrow V_H - 2s \left( 1 - \frac{M - n_H}{n_L} \right) &= 0 \quad (5a) \\
\frac{\partial \prod}{\partial n_L} &= V_L - s \left( 1 - \frac{M - n_H}{n_L} \right)^2 - 2n_L s \left( 1 - \frac{M - n_H}{n_L} \right) \frac{M - n_H}{n_L^2} = 0 \\
\Rightarrow \phi = \frac{M - n_H}{n_L} &= \sqrt{1 - \frac{V_L}{s}} \quad (5b)
\end{align*}
\]

Substituting equation \( (5b) \) into \( (5a) \), we get:

\[
V_H - 2s \left( 1 - \sqrt{1 - \frac{V_L}{s}} \right) = 0 \quad (6)
\]

Since there are no variables in equation \( (6) \), there is no optimal global solution. Thus, we compare profits from four distinct Corner Solutions, 1 - 4.

**Corner Solution 1: Sell both certain quality and probabilistic quality (“tiered” strategy)**

Here, we offer high quality to all the \( n_0 \) customers in segment H. Since \( M > n_0 \), the remaining capacity is offered to customers in segment L. To prevent H customers from buying this lower-priced product, segment L customers receive only a probabilistic product. We call this the tiered strategy since there are two levels of quality. The best profits from this approach are obtained by solving:
\[ n_H = n_0, \ M > n_H \]
\[ \Rightarrow \Pi_1 = n_0V_H + n_LV_L - n_LS\left(1 - \frac{M - n_0}{n_L}\right)^2 \]  \hspace{1cm} (7a)

Objective:

\[ \max \limits_{(n_L)} \Pi_1 = n_0V_H + n_LV_L - n_LS\left(1 - \frac{M - n_0}{n_L}\right)^2 \]  \hspace{1cm} (7b)

s.t. \( M \geq n_H \);

First-order conditions yield:

\[ \frac{\partial \Pi_1}{\partial n_L} = V_L - s\left(1 - \frac{M - n_0}{n_L}\right)^2 - 2n_LS\left(1 - \frac{M - n_0}{n_L}\right)\frac{M - n_0}{n_L^2} = 0 \]
\[ \Rightarrow n_L^* = \frac{\left(M - n_0\right)}{\sqrt{1 - \frac{V_L}{s}}} \]  \hspace{1cm} (8a)

\[ \Rightarrow \phi^* = \frac{M - n_0}{n_L} = \sqrt{1 - \frac{V_L}{s}} \]  \hspace{1cm} (8b)

\[ \Rightarrow p^* = 2\sqrt{s - V_L} \left(\sqrt{s - sV_L}\right) \]  \hspace{1cm} (8c)

\[ \Rightarrow \Pi_1^* = n_0V_H + n_L^*V_L - n_L^*S\left(1 - \frac{M - n_0}{n_L^*}\right)^2 \]
\[ = n_0V_H + 2\left(M - n_0\right)\left(1 - \sqrt{s^2 - sV_L}\right) \]  \hspace{1cm} (8d)

**Corner Solution 2: Sell only probabilistic quality ("degraded" strategy)**

Here, we ignore all the customers in segment H and offer only probabilistic quality to customers in segment L. We call this the degraded strategy because only the probabilistic quality is offered. The best profits from this approach are obtained by solving:

\[ n_H = 0, \ M > 0 \]
\[ \Rightarrow \Pi_2 = n_LV_L - n_LS\left(1 - \frac{M}{n_L}\right)^2 \]  \hspace{1cm} (9a)

Objective:

\[ \max \limits_{(n_L)} \Pi_2 = n_LV_L - n_LS\left(1 - \frac{M}{n_L}\right)^2 \]  \hspace{1cm} (9b)

s.t. \( M \geq 0 \);

First-order conditions yield:
\[ \frac{\partial \Pi_2}{\partial n_L} = V_L - s \left( 1 - \frac{M}{n_L} \right)^2 - 2n_Ls \left( 1 - \frac{M}{n_L} \right) \frac{M}{n_L^2} = 0 \]

\[ \Rightarrow n_L^* = \sqrt[2]{1 - \frac{V_L}{s}} \]

\[ \Rightarrow \phi^* = \frac{M}{n_L^*} = \sqrt[2]{1 - \frac{V_L}{s}} \]

\[ \Rightarrow p^* = 2\sqrt{s-V_L} \left( \sqrt{s-V_L} - \sqrt{s-V_L} \right) \]

\[ \Rightarrow \Pi^*_2 = 2M \left( \frac{1}{s} - \sqrt{s^2 - sV_L} \right) \]

**Corner Solution 3: Sell certain quality at \( V_H \).**

Here, the seller ignores customers in segment \( L \) and offer only the high quality product to the \( n_0 \) customers in segment \( H \). In this scenario, some capacity is left unsold since \( M > n_0 \). In straightforward fashion, we have:

\[ n_H = n_0 \text{ and } M \geq n_0 \]

\[ \Rightarrow \Pi^*_3 = n_0V_H \quad (11d) \]

**Corner Solution 4: Sell certain quality at \( V_L \).**

Here, the seller offers the high quality product at \( V_L \). In this scenario, the entire capacity is sold out since there are a large number of segment \( L \) customers in the market. It is also possible that some customers from segment \( H \) may buy the product at this price. We examine this strategy because capacity is greater than \( n_0 \); consequently, such a strategy may be superior to only selling the certain product to customers in segment \( H \) (Corner Solution 3). We have:

\[ \Pi^*_4 = MV_L \quad (12) \]

We are now in a position to compare the profits from the four corner solutions, 1 – 4. We have:

\[ \Pi^*_1 = n_0V_H + 2\sqrt{M - n_0} \left( \sqrt{s^2 - sV_L} \right) \]

\[ \Pi^*_2 = 2M \left( \sqrt{s^2 - sV_L} \right) \]

\[ \Pi^*_3 = n_0V_H \]

\[ \Pi^*_4 = MV_L \quad (13) \]

Comparing the profits from a tiered strategy versus a strategy of selling the certain product at \( V_H \), we obtain:

**Lemma 1:** The profits from the tiered strategy dominates the profits from selling only the certain product at \( V_H \).

**Proof:** Using equations (8d) and (11d), we obtain:
\[
\Pi_1^* - \Pi_3^* \\
= n_0V_H + 2M - n_0\left(-\sqrt{s^2 - sV_L} - n_0V_H\right) \\
= 2M - n_0\left(-\sqrt{s^2 - sV_L} \geq 0\right)
\]

The intuition for this result is straightforward. The tiered strategy is superior because it obtains some revenue from the unsold capacity associated with the strategy of selling only the certain product at \(V_H\). Given Lemma 1, we can exclude Corner Solution 3 from further consideration. We are now in a position to state our first Proposition.

**Proposition 1**: The profits from the tiered strategy dominate the profits from selling only the certain product at \(V_L\). Similarly, the profits from the degraded strategy also dominate the profits from selling only the certain product at \(V_L\).

**Proof**: For the first part, we use equations (8d) and (12) to obtain:

\[
\Pi_1^* - \Pi_4^* \\
= n_0V_H + 2M - n_0\left(-\sqrt{s^2 - sV_L} - MV_L\right) \\
= M(2s - 2\sqrt{s^2 - sV_L} - V_L) - n_0\left(s - 2\sqrt{s^2 - sV_L} - V_H\right)
\]

Since \(V_H > V_L\), we can prove that \((2s - 2\sqrt{s^2 - sV_L} - V_L) > (s - 2\sqrt{s^2 - sV_L} - V_H)\) if \(M > n_0\), so if we can prove that \(2s - 2\sqrt{s^2 - sV_L} - V_L > 0\), then we can say \(\Pi_1^*\) is always greater than \(\Pi_4^*\).

Check the relationship: \(2s - 2\sqrt{s^2 - sV_L} - V_L > 0\)

\[
\Rightarrow 2s - V_L > 2\sqrt{s^2 - sV_L} \\
\Rightarrow 4s^2 - 4sV_L + V_L^2 > 4s^2 - 4sV_L \\
\Rightarrow V_L^2 > 0, \text{ which is true } \Rightarrow \Pi_1^* > \Pi_4^*.
\]

The proof of the second part follows directly by comparing the profit elements in equation (13).

Proposition 1 is noteworthy because it demonstrates that the tiered strategy dominates covering the market at a price of \(V_L\). In fact, since even the degraded strategy dominates covering the market at \(V_L\), this is not being driven by the higher valuations associated with selling to customers in segment H. Rather, it demonstrates the superiority of offering probabilistic quality. Intuitively, this is because offering probabilistic quality expands the strategy space of the seller. Specifically, the seller can now also examine if targeting \(n_L > M\) enhances profits – if not, she can always resort to setting \(n_L = M\). This superiority of probabilistic quality, for all values of the distaste parameter, \(s\), speaks to the widespread profit opportunity inherent in this pricing strategy. As such, it is a key insight from our model and analysis. Indeed, many service organizations offer such a degraded strategy when no customers can get guaranteed high quality (e.g., restaurants that offer no reservations, theme parks that do not have separate short lines, etc.). As such, we conjecture that this is a large part of our parameter space.
Given Proposition 1, we can exclude Corner Solution 4 from further consideration. We therefore focus on the comparison between the tiered strategy and the degraded strategy. The findings from this comparison are characterized below:

**Figure 2: Optimality of Mixed and Pure Strategies**

\[
\frac{V_H}{2} \leq V_L
\]

\[
\begin{array}{c|c|c}
\text{DEGRADED} & \text{TIERED} \\
\frac{V_H}{2} & V_1 & \frac{V_H^2}{4(V_H - V_L)}
\end{array}
\]

\[
\frac{V_H}{2} > V_L
\]

\[
\begin{array}{c|c|c}
\text{TIERED} & \text{TIERED} & \text{TIERED}
\end{array}
\]

\[
V_1 & \frac{V_H}{2}
\]

**Proposition 2:** When the valuation of the H customers is not too different from the valuation of the L customers (i.e., \( \frac{V_H}{2} \leq V_L \)), the profits from the degraded strategy dominates the profits the tiered strategy as long as the distaste parameter is not too large, \( V_L < s < \frac{V_H^2}{4(V_H - V_L)} \). The reverse is true when \( s > \frac{V_H^2}{4(V_H - V_L)} \). However, when the valuation of the H customers is sufficiently different from the valuation of the L customers (\( \frac{V_H}{2} > V_L \)), the tiered strategy always dominates.

**Proof:** Using equations (8d) and (10d), we have:
\[ \Pi^*_L - \Pi^*_L = n_0 V_H + 2 (1 - n_0) \left( -\frac{s^2 - s V_L}{2} \right) - 2 M \left( -\frac{s^2 - s V_L}{2} \right) \]
\[ = n_0 \left( 1 - 2 \left( -\frac{s^2 - s V_L}{2} \right) \right) \]
\[ \Rightarrow \text{need to compare } V_H \text{ and } 2 \left( -\frac{s^2 - s V_L}{2} \right). \]

Two cases arise:
1. When \( \frac{V_H}{2} > s \Rightarrow V_H > 2 \left( -\frac{s^2 - s V_L}{2} \right) \Rightarrow \Pi^*_L \text{ is better} \)
2. When \( \frac{V_H}{2} \leq s \)

\[ \Rightarrow \text{need to compare } V_H \text{ and } 2s - 2 \sqrt{s^2 - s V_L} \]
\[ \Rightarrow \text{need to compare } 4s(V_H - V_L) \text{ and } V_H^2 \]
\[ \text{when } s > \frac{V_H^2}{4(V_H - V_L)} \Rightarrow \Pi^*_L \text{ is better} \]
\[ \text{when } V_L < s < \frac{V_H^2}{4(V_H - V_L)} \Rightarrow \Pi^*_L \text{ is better} \]

The intuition behind Proposition 2 is as follows. When the valuations are relatively close, the degraded strategy is effective only when the distaste parameter is relatively small (\( V_L < s < \frac{V_H^2}{4(V_H - V_L)} \)). That is, relying solely on probabilistic quality is effective only when for small values of the distaste parameter. As the distaste parameter increases, it becomes more difficult to extract profits via probabilistic quality; hence, the seller also turns to including customers from segment H via the mixed strategy. Next, when the valuations are relatively apart, the high valuations of the segment H customer motivates the seller to always include sales to this segment via the tiered strategy.

We are now in a position to derive our results pertaining to the design and pricing of probabilistic products. We have:

**Proposition 3:** Whenever the seller finds it optimal to include a probabilistic product:

1) The number of L customers targeted is *decreasing* in the distaste parameter, \( s \), but *increasing* in the valuation parameter, \( V_L \).

2) The probability associated with quality, \( \phi \), is *increasing* in the distaste parameter, \( s \), but *decreasing* in the valuation parameter, \( V_L \).

3) The price of the probabilistic product, \( p \), is *increasing* in the distaste parameter, \( s \).

4) The price of the probabilistic product, \( p \), is *increasing* in valuation, \( V_L \), when the distaste parameter is sufficiently large (\( s > \frac{4V_L}{3} \)). It is *decreasing* in the valuation, \( V_L \), when the distaste parameter is sufficiently small (\( V_L < s < \frac{4V_L}{3} \))
Proof: Part 1 follows directly from equations (8a) and (10a). Part 2 follows directly from equations (8b) and (10b). Parts (3) and (4) are proved in the Appendix.

There are several noteworthy elements described in Proposition 3. First, the characterization of probabilistic quality is invariant to whether the seller follows a tiered strategy or degraded strategy. Second, increases in the distaste parameter decrease the number of segment L customers. As distaste increases, buyers become more sensitive to lack of quality; hence, the seller responds by targeting fewer segment L customers. This reduced targeting also increases the probability of receiving quality. In contrast, increases in the valuation, $V_L$, increase the number of segment L customers targeted. This is because, valuation, unlike distaste which only impacts disutility, also has a separate effect on increasing willingness to pay. Apparently, this effect dominates; hence, increases in $V_L$ call for targeting more segment L customers, even as the quality offered to them degrades.

Next, Proposition 3 reveals, quite counter-intuitively, that price is increasing in the distaste parameter, $s$. The explanation is as follows. As distaste increase, the seller responds by designing a product with higher probability in order to reduce increased disutility. This enhanced product is then offered at a higher price.

Finally, the impact of changes in $V_L$ on price is dependent on the value of the distaste parameter. Recall that increases in $V_L$ decreases the probability associated with the probabilistic good (8b and 10b) and thereby also lowers price. However, when $s$ is relatively large ($s > \frac{4V_L}{3}$), the impact of an increase in $V_L$ to decrease probability is muted. As such, the corresponding decrease in probability does not lead to much lowering in price. But, as before, $V_L$ also contributes to increased willingness to pay and thereby contributes to increasing price. Overall, in this environment, the impact of an increase in $V_L$ is to increase price – the latter effect dominates. In contrast, when $s$ is relatively small ($V_L < s < \frac{4V_L}{3}$), the impact of an increase in $V_L$ to decrease probability is amplified. As such, the corresponding decrease in probability leads to a substantial decrease in price. Of course, $V_L$ also contributes to increased willingness to pay and therefore argues for increases in price. However, in this environment, the impact of an increase in $V_L$ is to decrease price – the former effect dominates.

Choice of Market Segments

Here, we consider a scenario where, in addition to segment H customers, the seller has a choice of two Segment L customers: $(s_1, V_{L1})$ and $(s_2, V_{L2})$. The first segment has a higher distaste parameter but a higher valuation as well. Thus, it is interesting to ask: Which of these two segments should the seller choose?

To impose some structure on this problem, we specify the following marketplace relationship between valuations and the distaste parameters:

$$V_L = \alpha s^\beta, \quad 0 \leq \beta < 1$$

(14).

Such a relationship implies that as the distaste parameter increases, valuations also increase. However, the valuations do not increase as fast as the distaste parameter. Clearly, this stringent condition is likely to hold in real-world marketplaces and suggests that sellers would be pushed toward choosing the segment with lower $s$ and lower valuation. However, we show that this is not always the case:
**Proposition 4**: If the distaste parameter, \( s \), is below some critical value, the seller will choose the segment with lower \( s \) and lower valuations. In contrast, if the distaste parameter, \( s \), is above some critical value, the seller will choose the segment with higher \( s \) and higher valuations.

**Proof**: See Appendix.

The intuition for the result in Proposition 4 is as follows. When \( s \) is small, it turns out that \( n_L \) is quite sensitive to increases in \( s \) (in fact, when \( s \) equals its lower bound, \( V_L \frac{\partial n_L^n}{\partial s} = -\infty \)). This sharp decrease in the size of segment L customer targeted reduces the profitability of offering probabilistic quality and causes the seller to choose the segment with lower \( s \) and lower valuations. In contrast, when \( s \) is larger, \( n_L \) is less sensitive to increases in \( s \). Moreover, increase in \( s \) actually lead to better price realization, causing the seller to actually increase prices. These two facts cause the seller to choose the segment with higher \( s \) and higher valuations. In essence, the seller chooses to move rightward even though valuations do not rise as steeply as distaste.

**Capacity Choice Endogenous**

It is natural to ask, how are the seller’s choices impacted when capacity choice is made endogenous. Thus, we set the cost of capacity as \( \gamma M^2 \). We obtain the following results which closely mimics Proposition 3:

**Proposition 5**: Whenever the seller finds it optimal to include a probabilistic product:

1) The number of L customers targeted is decreasing in the distaste parameter, \( s \), but increasing in the valuation parameter, \( V_L \).

2) The probability associated with quality, \( \phi \), is increasing in the distaste parameter, \( s \), but decreasing in the valuation parameter, \( V_L \).

3) The price of the probabilistic product, \( p \), is increasing in the distaste parameter, \( s \).

4) The price of the probabilistic product, \( p \), is increasing in valuation, \( V_L \), when the distaste parameter is sufficiently large ( \( s > \frac{4V_L}{3} \) ). It is decreasing in the valuation, \( V_L \), when the distaste parameter is sufficiently small ( \( V_L < s < \frac{4V_L}{3} \) ).

**Proof**: See Appendix.

In effect, even with making capacity endogenous, the properties and characteristics of selling probabilistic quality remain invariant.

Next, we find that when capacity is also a decision variable, the firm may sometimes find it profitable to limit capacity and only sell the certain product at \( V_H \) to all of the segment H customers. This occurs when the cost of capacity is relatively high. However:
Proposition 6: When \( V_L < \frac{V_H}{2} \) and \( n_0 > \frac{s - \sqrt{s^2 - SV_L}}{\gamma} \) or \( V_L \geq \frac{V_H}{2}, s < \frac{V_H^2}{4\ell - V_L} \), and \( n_0 > \frac{s - \sqrt{s^2 - SV_L}}{\gamma} \), the seller finds it profitable to eschew probabilistic quality and limits itself to selling the certain product at \( V_H \). Otherwise, the seller chooses a level of capacity such that \( M > n_o \) and employs probabilistic selling.

Proof: See Appendix

Broadly, Proposition 6 reveals that when the valuations of the H segment are relatively large and when they are numerous, the capacity choice is such that only H customers are served and there is no probabilistic quality. These conditions are more likely when capacity is more expensive. However, when these conditions do not hold, Proposition 6 reveals that a seller may optimally choose to build capacity that exceeds the number of H customers in the market. In this event, the seller also employs probabilistic selling. In essence, we find that probabilistic quality can emerge even when capacity choice is endogenous.

IMPLICATIONS

One of the goals of analytical models is go beyond current managerial practice (Shugan 2002). In this spirit, we offer a formal analysis on the design and pricing of probabilistic quality. Interestingly, we are seeing initial use of such pricing schemes across many service industries. Given the high growth in services and technologies that further limit arbitrage among buyers; we expect such pricing schemes to become even more prevalent in the future.

A key finding from our modeling efforts is the delineation of the profit enhancement available from employing probabilistic quality. Crucially, this improvement is not contingent on critical values of a key parameter in our model, namely, the distaste for the absence of quality. Rather, it holds all across the parameter space.

Second, we are able to explicitly characterize the design and pricing of probabilistic quality. We also derive how these decision variables are impacted by changes in the distaste parameter as well as valuations possessed by the target segment. The effects are not always obvious. For example, price always increases in the distaste parameter. Similarly, the impact of valuation on price is contingent on the magnitude of the distaste parameter.

Third, we are able to characterize situations where the seller should choose a tiered strategy and those situations where the seller should choose a degraded strategy. Here, our model compares the benefits of focusing purely on low valuation customers versus the benefits of including a segment that has high valuations. We show that the ability to extract profits via the degraded strategy, as captured in the distaste parameter, is an important determinant of this decision.

Fourth, we are also able to shed light on how managers may choose the segment to offer the probabilistic quality. We find that even though valuations may not increase as steeply as distaste, the seller may sometimes find it optimal to target segments with high valuations and high distaste. This is an important insight because given the shallow rise in valuation, intuition would suggest otherwise.

Finally, we are able to demonstrate that the design and pricing of probabilistic quality is invariant to the capacity choice decision. Further, we find that it may be optimal for firms to actually build more
capacity than the number of customers willing to purchase this capacity at a high price. In essence, we find that probabilistic quality can emerge even when capacity choice is endogenous.

Of course, our work is not without limitations. It would be useful to examine how are results are impacted by different functional forms, especially with respect to the distaste for quality. It would also be useful to examine how our results are impacted by the introduction of competition. We hope our efforts will stimulate future work along these lines.
REFERENCES


