

ESCALATING BEHAVIOR TO LOSING PROJECTS: AGENCY THEORY PERSPECTIVE

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ABSTRACT

This paper analyzes how the escalating behavior of an investment manager is affected by the presence and absence of high personal responsibility and information asymmetry using the laboratory decision making experiment. Drawing on agency theory, it is found that high personal responsibility and information asymmetry result in escalation of commitment to a failing projects. It is further evident that investment managers working in collective-oriented culture in Pakistan are more vulnerable to get entrapped in escalating behavior than their counterparts working in individualistic-oriented cultures. From agency perspective, this escalation of commitment arises from the divergence of interest between agent (manager) and principal (shareholders) and thus the proper incentives and controls should be practiced to align the interests of agent and principal in order to curb the escalating decisions of an agent. In this paper, we also followed the pattern of decision cases of (Harrison and Harrell, 1993). This decision-making experiment was focused on analyzing the influence of high personal responsibility and information asymmetry on managers' commitment to seemingly losing projects. Because of this two factored analyses i.e. high personal responsibility and information asymmetry, we replicated the decision task of (Schulz and Cheng, 2002) and accordingly, the subjects were randomly assigned the different decision tasks to perform.

INTRODUCTION

People exhibit their escalating or de-escalating behavior in context of socio-cultural milieus. Socio-cultural environment is diverse and dynamic in nature, therefore people have varied values, customers, practices, organizational constraints and opportunity structures (Albert, 2002). This diversity underscores the need to re-apply these theories and analyze their explanatory

power in defining escalating behavior of decision makers working in varied socio-cultural environment. In the bulk of prior research, escalating behavior to losing projects has been empirically observed and explained in the light of certain theories. Among the prominent theories (Staw, 1976) used Self-Justification theory (SJT) which explains that a decision-maker has tendency to escalate the commitment to failing projects in order to justify his/her prior erroneous behavior on the basis of retrospective rationality. Whyte, (1986) applied prospect theory (PT) which asserts a decision-makers risk-preference attitude in the face of uncertainty and found escalating behavior attributable to sunk cost. In the approach avoidance theory (AAT), the driving forces that escalate commitment are more powerful than restraining forces that de-escalate or abandon commitment (Keil, et al., 2000). Conlon and Howard, (1993) argued that the goal and completion effect theory as better alternative for explaining escalating behavior. Harrison and Harrell, (1993) used agency theory and found information asymmetry as a major contributing factor in escalating commitment. In this paper, we mainly take agency theory perspective to explain the escalation of commitment phenomenon. In agency theory, the agency relation is one in which one party (principal) delegates some decision-making authority to another party (agent) to perform some services for the principal (Kiser, 1999; Jensen and Meckling, 1976). The classical financial theory postulates that managers have to focus at decisions that maximize the wealth of shareholders. However, in practice most of investment managers are focused at maximizing their personal utility rather than shareholder's wealth. In the context of agency theory, this divergence of focus arises from the non-alignment of interests between agent (manager) and principal (shareholders). Once the manager implements the initial investment decision, he/she needs to review the projects' performance and decide on whether to abandon the project or to continue it depending on the feedback information. This reinvestment decision should be made on the basis of economic rationality and that should be in the best interest of shareholders. But given the non-alignment of interest between both parties, it is highly likely that the manager may

pursue the failing course of action based on bounded rationality rather than economic rationality even if such action may eventually be unprofitable to shareholders.

Whyte, et al., (1997) argue that there exists well documented bias towards persistency or escalation of commitment to the failing course of action on the part of the manager. The term escalating behavior refers to the tendency for managers to persist with failing projects (Brockner, 1992). The prior research in this regard have found two factors “the high personal responsibility and information asymmetry” as major contributors to managers’ escalation of commitment to failing projects (For details see, Schulz and Cheng, 2002, Greer and Stephens, 2001, Jensen and Meckling, 1976). This paper is aimed at examining these factors in two ways. First, it analyzes whether the tendencies of escalating behavior towards losing projects differ when the managers are highly responsible vs. low responsible for initial investment decision. Second, this paper examines the impact of information asymmetry on the escalation decision of managers who initiated the investment project in first place. The remainder of the paper is structured as follows. In the next section, the authors elaborate the research design and decision task. Section 3 analyses the results of the decision task. Finally, section 4 concludes and provides implications of this study.

RESEARCH METHOD

Research Design: In this decision-making experiment, the total 62 subjects who were doing full-time job into different organizations and doing part-time their MBAs in evening program in Pakistan participated. The average age and working experience of the subjects were 32.6 (SD = 4.2) years and 4.95 (SD = 2.85) years respectively. In designing the decision-making experiment, we followed the pattern of decision cases of (Harrison and Harrell, 1993) and presented each subject with four different projects named A, B, C and D. Each project contained the historical and projected financial and economic information and hurdle rate (for remaining project life). Some of which is shown in (Table 1). According to that information the firm’s value will be maximized by continuing projects A and C since their IRR (for remaining

period) is higher than hurdle rate. With this criterion, the projects B and D are losing projects and need to be abandoned. The provision of those both situations of continuing the successful projects and abandoning the failing ones into our four hypothetical projects were aimed to assess the escalating behavior of the subjects to apparently losing projects under the conditions of high personal responsibility and information asymmetry.

Decision Task: This decision-making experiment was carried in two parts (Schulz and Cheng, 2002). In the first part, the subjects were randomly given one of the following added information:

- (i) That they initiated the project in first place [and thus imparting the higher sense of personal responsibility.]
- (ii) That they did not initiate the project in first place [and thus imparting lower sense of personal responsibility.]

In the second part, the subjects were asked that they initiated the project in first place and were randomly given one of the following added information:

- (i) That historical and projected financial and economic information was only available to them [and thus creating information asymmetry.]
- (ii) That historical and projected financial and economic information was available to other stakeholders of company too [and thus creating information symmetry.]

The subjects were asked to decide on whether each project should be continued or abandoned. They were further asked to indicate the level of determination in their decisions by ticking the six-point (1-6) likert-scale. Where the values of 1, 2 and 3 represent highest, moderate and lowest level of determination respectively in decision to abandon the project and the values of 4, 5 and 6 show lowest, moderate and highest level of determination respectively in decision to continue the project. In other way, in this six point (1-6) likert-scale, the starting- point value of “1” equals to “fully determined to abandon the given project” and the

ending-point value of “6” equals to “fully determined to continue the given project.”

In manipulation check effort, the subjects were first briefed about each project scenario and then had a discussion to evaluate their understanding about the level of responsibility and the existence of information asymmetry and information symmetry indicated in each project. It was found that subjects were fairly well aware of the information regarding each project and their responsibility to decide the future course of action.

TABLE-1
FINANCIAL INFORMATION OF THE PROJECTS

Information	Project A	Project B	Project C	Project D
Net annual cash flows	*PRs 4000,000	PRs 100,000	PRs 1500,000	PRs 500,000
IRR (entire project life i.e. seven years)	18.08%	16.92%	14.89%	13.57%
IRR (remaining project life i.e. three years)	38.32%	-1.95%	20.12%	-6.18%
Hurdle rate (for remaining project life)	16.5%	16.5%	16.5%	16.5%

*PRs stands for Pakistan Rupee.

TABLE-2(A)
**MEAN [SD] SCORES IN FIRST PART OF
DECISION-MAKING EXPERIMENT**

	Project A	Project B	Project C	Project D
Group with high personal responsibility	5.81 [.40]	*4.38 [.89]	5.50 [.73]	*4.06 [.99]
Group with low personal responsibility	5.69 [.48]	1.19 [.40]	5.19 [.66]	1.13 [.34]

*The mean values differ significantly between two groups on these projects ($p < .000$).

TABLE-2(B)
MEAN [SD] SCORES IN SECOND PART OF
DECISION-MAKING EXPERIMENT

	Project A	Project B	Project C	Project D
Group with information asymmetry	5.88 [.34]	**4.63 [.72]	5.63 [.50]	**4.38 [.72]
Group with information symmetry	5.75 [.45]	1.44 [.51]	5.25 [.68]	1.25 [.45]

**The mean values differ significantly between two groups on these projects ($p < .000$).

RESULTS

The primary focus of this study was to examine the escalating behavior of subjects to losing projects i.e. B and D. The results in Table-2 (A) show that the subjects who initiated the projects and were charged with high personal responsibility have greater determination to continue the failing projects i.e. B and D than their counterparts who did not initiate the project. The mean values of these two groups are significantly different applying t-test for decision on project B ($X = 4.38$ vs. 1.19 , $t = 12.99$, $p < .000$) and project D ($X = 4.06$ vs. 1.13 , $t = 11.06$, $p < .000$). This is to explain that managers often discount negative feedback information and commit additional resources to failing projects in order to justify their initial investment decisions (Staw and Fox, 1977). Furthermore, Salter and Sharp, (2001) suggest that owing to collective cultures' need for group affiliation, its members are very concerned for maintaining face-value. Unlike the West, most of the Asian countries have collective culture. Pakistan is one of them. In that context, it is highly likely that managers who made the original investment decision could escalate their commitment to apparently losing projects because of mainly two major reasons. Firstly, those managers are not ready to admit that their initial investment decision was flawed and they express it by sticking to the losing project. Secondly, since abandoning the project puts the career of manager at stake and therefore they seem to bet that their

escalation decision may eventually turn the failing project into profitable one in future and that they could save their face.

The results in table 2-B indicate that the managers become more determined to persist with losing projects i.e. B and D, if high personal responsibility is coupled with information asymmetry factor. The mean values of these two groups are significantly different applying t-test for decision on project B ($X = 4.63$ vs. 1.44 $t = 15.29$, $p < .000$) and project D ($X = 4.38$ vs. 1.25 , $t = 15.50$, $p < .000$).

This decision-making experiment has some limitations. Firstly, it did not consider the individual factors such as managerial decision-making experience and salary package and exogenous factors such as the political interference that could influence the decision of manager regarding his/her commitment to losing projects. One of the major limitations voiced in studies defining the phenomenon of escalating behavior is the use of student samples (Whyte, *et.al.*, 1997; Schulz and Cheng, 2002). The behavior of those student respondents may differ from actual managers who experience real investment decisions. To overcome that limitation, we selected the subjects who were working at different organizations and hence carried real experience of investment decisions and doing part-time their MBA degrees (in evening programs) and hence carried enriched academic background. Nonetheless, the results of this study may be interpreted with some caution.

CONCLUSION AND FUTURE IMPLICATIONS

The paper analyzes how the escalating behavior of manager is affected by the presence and absence of high personal responsibility and information asymmetry. The results of this study are in line with the findings of other studies that high personal responsibility and information asymmetry result in escalating behavior to losing projects (Schulz and Cheng, 2002; Greer and Stephens, 2001; Staw and Fox, 1977; Jensen and Meckling, 1976). Managers make decisions in context of socio-cultural milieus. The subjects (belonging to collective society) in this study exhibited relatively higher intensity of escalation of commitment to failing

projects than the subject (belonging to individualistic society) did in the study of (Harrison and Harrell, 1993). Some cross cultural studies concluded that the managers working in China, Hong Kong and Taiwan are more willing to escalate commitment to apparently losing projects than their American counterparts (Chow, *et.al.*, 1996; Tse, *et.al.*, 1988). It shows that managers working in collective-oriented culture are more vulnerable to get entrapped in escalating behavior than their counterparts working in individualistic-oriented culture. As discussed earlier, from agency perspective, this escalation of commitment arises from the divergence of interest between agent and principal. (McColgan, 2001) points out that if the investment project fails, the manager bears the entire cost of failing while if the investment project succeeds, the manager captures only a fraction of the benefits. Therefore, proper incentives and controls are needed to align the interests of agent and principal. The agency theorists have suggested some potential mechanisms to curb or control the escalating behavior of an agent (manager) by aligning his/her interests with that of principal (shareholders) like equity ownership between both parties (Jensen and Meckling, 1976) , mobilizing efficient capital and labor markets as information system (Fama, 1980) and devising outcome-based contracts (Eisenhardt, 1989). More over some other factors have also been identified that could promote de-escalation behavior such as changes in top management (Ross and Staw, 1993), availability of alternative investment (Keil, 1995), establishing minimum target levels and making the consequences of failure appear less frightening (keil and Robey, 1999), split of responsibility for starting and evaluating projects (Barton et al, 1989) and regular monitoring of projects (Drummond, 1995). This study will certainly stimulate further research on this relatively unexplored area in Pakistan and the future studies should focus on developing de-escalation model within socio-cultural context milieus.

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