IMPACT OF “ADVERSE SELECTION” ON MANAGERS’ PROJECT EVALUATION DECISIONS
Agency theory

- Predicts how the availability of information and incentives influences managers’ decisions.
- Principal-agent model

1. Agents will act in their own self-interest
2. Goal conflict can exist between principals and agents
3. Outcomes of managers’ decisions can be easily measured
   - Agents are more risk-averse than principals
Introduction

- Agency theory can be used to explain decisions to continue a failing project. When the conditions for adverse selection exist—an agent has private information and an incentive to shirk—such decisions, apparently irrational from a principal's perspective, may be rational from the agent’s perspective.

- Economic theory assumes a firm’s managers will reach decisions that maximize the profitability of their firms.

- Managers who initiate projects that become unprofitable are more likely to continue supporting those projects than managers who did not initiate them.
Issue

- When adverse selection exists, the potential for goal conflict arises, and agency theorists predict that agents will act in their own self-interest, at the expense of their principals. The agent may view behavior that seems irrational from the principal’s point of view [such as continuing an unprofitable project] as rational.

- Agency theorists would posit that companies can avoid the adverse selection problem by developing (1) more complete information systems, thus eliminating private information, or (2) contingent incentive systems, which align the interests of principals and agents.
Methods

- Of the 78 individuals who participated in the research, 54 were men and 24 were women. The typical subject was about 30 years old, had eight years of business experience, and earned an annual salary of about $38,000.
- To control for individual differences, we randomly assigned subjects to one of two groups. The people in group two, the experimental group, were told they had initiated the four projects and were to be held responsible for the success or failure of each project.

  (1) as the managers of these projects, they possessed private information about the projects’ projected economic performance that was not available to others

  (2) a decision to discontinue a project would cause others to believe it was a failure, thus damaging their reputations and causing a desirable external job offer to be withdrawn.
Methods-1

- However, these subjects did not experience the conditions associated with adverse selection. Their instructions indicated:
  1. Information about the projects’ projected economic performance was readily available to others.
  2. A decision to discontinue a project would have no effect on their reputations or on the desirable external job offer.
On the basis of the information summarized in Table 1, the profits of the firm would be maximized by continuing projects A and C, since each had a projected internal rate of return during its remaining lifetime above the 16 percent hurdle rate, and discontinuing projects B and D, each of which had a projected internal rate of return well below both the hurdle rate and the rate of return of the alternative investment in bonds.

Experimental group subjects to respond to the following manipulation check question: "Without looking back, how readily available is the interim information which indicates the success or failure of the projects?" Of the 39 respondents, 36 (92%) responded correctly to the question, indicating they were aware these economic projections were not available to others.
Result

- We used a repeated-measures analysis of variance (ANOVA) to determine if there were any differences between the responses of the subjects in the two groups. The between-subjects variable, adverse selection, had two levels. Case was a within-subjects variable with four levels (A, B, C, and D). The ANOVA revealed highly significant effects for adverse selection.

- \( F_{1176} = 24.38, p < 0.0001 \), case(\( F_{3228} = 138.49, p < 0.0001 \)), and an the interaction of the two (\( F_{3228} = 8.30, p < 0.0001 \)). A t-test was used to further compare the two groups' decisions; in the following summaries of results, means for the experimental group appear first. No significant differences were observed for project A (x = 1.68 vs. 1.92, t = 0.78, p < .2175) and for project C (x = 3.23 vs. 3.42, t = 0.43, p < .3343). As predicted, significant differences were observed between the experimental and control subjects for decisions on project B (x = 4.75 vs. 7.53, t = 5.15, p < .0001) and project D (x = 6.62 vs. 8.66, t = 3.76, p < .002). We consider these results supportive of our proposition.