Mitigation of Overcommitment in M&A Decision-Making: Explorations from the Lab and the Field

ABSTRACT

The prevalence of managerial biases is well documented in strategy research. Yet, we know relatively little about their potential mitigation. In this study, we explore the mitigation of managerial overcommitment in the M&A decision-making process. Drawing on the psychology literature we propose two distinct mitigation approaches: Opposite reasoning, which actuates the consideration of outcomes that are diametrically opposed to currently hold assumptions, and disclosive reasoning, where the anticipation of justification requests prompts a more careful evaluation of information. In an experimental study, we find significant evidence for the effectiveness of both debiasing strategies. We then examine these approaches outside of the lab. Drawing on qualitative field data of 32 M&A departments, we explore the adoption and perceived impediments of these approaches in organizations with different organizational structures.

KEYWORDS:

Behavioral Theory, Decision Processes, M&A
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Large-scale corporate investment decisions, like mergers and acquisitions, are frequently subject to a number of dysfunctional behavioral tendencies such as anchoring bias (Malhotra, Zhu, & Reus, 2015), escalating commitment (Haunschild, Davisblake, & Fichman, 1994), illusion of control (Duhaime & Schwenk, 1985) managerial overconfidence (Zollo, 2009) or bandwagon effects (Haunschild, 1993). Early on, research has highlighted that “decisions on whether or not to acquire, and which of all possible targets to consider, are very susceptible to cognitive simplification” (Duhaime & Schwenk, 1985:288). Anecdotal evidence of misjudged synergy potential, hazardous overpayment, and spectacular acquisition failures is abundant. Yet, despite the growing evidence for the systematic errors in strategic decision-making, our current understanding of the adoption and effectiveness of different mitigation strategies remains relatively obscure (Powell, Lovallo & Fox, 2011).

Following the definition of biases as the gap between normative and descriptive decision-making (Tversky & Kahneman, 1974), debiasing can be conceptualized as the attempt to approximate the normative ideal (Larrick, 2004). Others suggested thinking of biases and debiasing as a pair of ‘mental contamination’ and ‘mental correction’(Wilson & Brekke, 1994). Since Fischhoff’s foundational work (1982) a branch of psychology research has proposed a range of debiasing approaches. These prescriptive cognitive strategies, or “recipes”, represent a compromise between a strategy that approximates the normative ideal, but can be accessed and implemented given ordinary cognitive limitations on memory and computation approaches (e.g. Arkes, 1991; Larrick, 2004; Soll, Milkman, & Payne, 2016). Yet, mitigation approaches at the individual level have been countered by voices of skepticism. Some have argued that cognitive biases are so deeply engrafted in executives’ knowledge structures, automatic behavioral patterns, and psycho-physical distortions, that the realities of organizational practice will almost always abrogate the effectiveness of these techniques (e.g. Powell et al., 2011; Thaler & Sunstein, 2008). Similarly, Kahneman and Klein (2009) assert that attempts to correct individual cognitive errors are less conducive than intervention at the organizational level, about which we still know very little. Therefore, Powell and colleagues (2011) suggested that questions surrounding the “psychological architecture” – whether and how structures and processes of collective choice can be improved – represent one of the most relevant and most puzzling areas for further behavioral strategy research.

In this study, we seek to shed more light on the mitigation of decision-making biases in the strategy process. To do so we focus on managerial overcommitment to an identified acquisition opportunity throughout the evaluation process, which has been frequently documented in the M&A context. Drawing on the psychology literature we propose two distinct mitigation approaches; oppositive reasoning, which actuates the consideration of outcomes diametrically opposed to the assumed one, and disclosive reasoning, in which social reputation aspects prompt a more careful evaluation of information. To explore both the adoption and effectiveness of these approaches we pursue a multi-method approach. First, emulating previous experimental research in this domain (Haunschild et al., 1994; Puranam, Powell & Singh, 2006), we simulate the target evaluation process in a lab experiment with 120 participants. Inducing triggers for oppositive and disclosive reasoning, we find that both debiasing approaches significantly reduce the likelihood of overcommitment. After having identified these micro-mechanisms in the “sterile” set-up of the lab, we seek to complement them with finer-grained and richer processual insights from a variety of organizational contexts. To do so, we draw on qualitative field data of 32 M&A departments and seek to explore the adoption and perceived impediments of such approaches in organizations with different organizational structures.
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THEORY

Overcommitment in M&A Decision-Making. The propensity to “continue an endeavor once an investment in money, effort, or time has been made” (Arkes & Blumer, 1985:124) even if the course is a dead-end, describes the phenomenon of escalating commitment to a previously chosen course of action (Staw, 1981). Previous research developed various explanations why such behavior occurs in organizations (Sleesman, Conlon, McNamara & Miles, 2012), including individual accountability, competitiveness, or social reputation (Haunschild et al., 1994; Puranam et al., 2006). Mechanisms to respond effectively remain, however, unexplored but are called for (Powell et al. 2011; Sleesman, Lennard, McNamara & Conlon, 2018).

High-stake strategic decisions, such as decisions related to corporate mergers and acquisitions (M&A), are characterized by complexity, ambiguity, and lack of structure in which the amount of available information frequently exceeds what is reasonably processable by the involved decision-makers (Duhaime & Schwenk, 1985). To cope with that, individuals are found to base their decisions on heuristics and cognitive simplifications (e.g. Tversky & Kahneman, 1974). In their study on escalating commitment in corporate acquisitions, Haunschild and colleagues (1994) conceptualize overcommitment in M&A decision-making process as being too committed towards a certain target candidate, when the rational decision would be to walk away from the acquisition. Similarly, Puranam and colleagues (2006) study due diligence failure and examine to what extent escalation of commitment towards an identified acquisition opportunity triggers the consideration of sunk costs when deciding whether to continue or to withdraw from the transaction. Despite these valuable insights into the antecedents of overcommitment in M&A contexts, potential means to mitigate this bias remain, however, undressed.

Opposite Reasoning as Mitigation Approach for Overcommitment. Introduced as “Consider the Opposite”, psychology research proposed that “any inducement for decision-makers to consider that matters might be other than what they seem, especially an inducement to consider possibilities diametrically opposed to one’s assumptions, would have an ameliorative effect on judgemental bias” (Lord, Lepper, & Preston, 1984:1231). Similar approaches have been discussed in the psychology literature as a suitable cognitive strategy for addressing biases based on a narrowed recruitment of attributes and alternatives on choice as well as inconsistent judgment of stimuli – such as overcommitment (Arkes, 1991). We subsume these processes under opposite reasoning. Prior literature provides empirical evidence underpinning the effectiveness of Opposite reasoning in a number of different biases, including overconfidence (Koriat, Lichtenstein, & Fischhoff, 1980; Hoch, 1985). By “priming stimuli other than the ones that would normally be accessed” (Arkes, 1991:494), individuals are prompted to seek and evaluate new information, thereby expanding a previously too narrow set sample of evidence, thus making it more representative. After the priming occurred this new causal link will affect the decision-making by influencing the same mechanism that initially led to the bias; just as causal chains induced the initial decision, new causal chains triggered by the new stimuli, influence the decision-making process, thereby reducing the bias. Due to the simplicity of the strategy, decision-makers can easily internalize opposite reasoning – and once internalized no external stimulus must be in effect. In their study on cures for anchoring effects, Mussweiler, Strack, and Pfeiffer (2000) inspire to test for the strategy’s effectiveness in an M&A context, as anchoring is evidently relevant in bidding situations when determining an appropriate premium for an acquisition target (Malhotra et al., 2015). Given that in a deal initiation the alternative choices are direct opposites – continuation or withdrawal – and that the impact of the bias is the selection of the wrong alternative, underlines the technique’s applicability as a debiasing strategy in an M&A context. Hence, our first hypothesis is:

H1 – Opposite reasoning reduces overcommitment in the pre-deal phase of M&A
Disclosive Reasoning as Mitigation Approach for Overcommitment. Exposure to the expectation that you may have to justify your decisions to others and be held accountable for the consequences is at the heart of a significant body of psychology research. Evaluating accountability concepts on various domains, including judgment accuracy, social perception has been rapidly increasing (Lerner & Tetlock, 1999). The approach proved to be a notably successful technique to compensate for various biases (Lerner & Tetlock, 1999) as it motivates individuals to spend more effort in considering information, implications, and alternatives (Huber & Seiser, 2001). We subsume these approaches under disclosive reasoning. After being exposed to the information, that they would have to explain their decision-making logic to an audience, decision-makers tend to “think more deeply than they would left to their own devices” (Larrick, 2004).

Disclosive reasoning induces behavior incentivized by a potential gain or loss of social benefits through the disclosure of the own reasoning process – e.g. avoiding embarrassment, losing social reputation, or making a favorable impression (Larrick, 2004). Given the abstract nature of social reputation, a direct impact on other individuals wealth or well-being is not even a prerequisite for disclosive reasoning to be effective. Considering, however, decisions in M&A as explicitly relevant for various groups of stakeholders, especially for shareholders as it potentially affects their wealth immediately, supports our proposition that disclosive reasoning can improve the involved decision-making. In contrast to the rather domain-general oppositive reasoning method, it is possible to implement disclosive reasoning in an M&A context in a domain-specific manner, by having decision-makers explain their specific decision to affected stakeholders, thereby linking it to one specific issue. A translation of this strategy to a deal initiation context would occur in formal mechanisms on the organizational level (e.g. letters to shareholders). Given the dichotomous characteristic of the central task in a deal initiation setup (deciding between continuing and withdrawing from the transaction process), considering more information and alternatives implies, in fact, the consideration of the opposite. This, in turn, reveals a close relatedness to the oppositive reasoning strategy. Given these considerations, we propose the strategy to be effective in a pre-deal M&A context, too:

**H2 – Disclosive reasoning reduces overcommitment in the pre-deal phase of M&A**

**METHODS AND DATA**

A standard methodological approach in social psychology, lab experiments are increasingly common in the strategy literature (Powell et al., 2011; Di Stefano & Gutierrez 2019). Despite their strength in isolating causal mechanisms through random assignment, their usefulness is sometimes put into question because they “abstract away many real-world complications” (Billinger, Stieglitz & Schumacher, 2014:96). Following calls that experiments “cannot exist without shared understandings and collective meanings, and they cannot be evaluated without data that reflect their dynamic and interactive nature” and should thus be complemented with qualitative field data (Schwenk, 1982; Fine & Elsbach, 2000), we adopt a multi-method approach.

We first conduct a lab experiment, which closely follows related work in this domain to simulate an M&A transaction process (Haunschild et al., 1994, Puranam et al., 2006). We run the experiment with 120 participants, which assumed the role of a manager responsible for the conduction of a target selection and a subsequent due diligence process in a computer-based simulation. After being exposed to overcommitment inducing manipulations (being personally responsible for the decision to acquire a target, having competition for it, and being told that the process outcome will be published) the participants were faced with increasingly adverse information concerning the expected value of the target. At the end of each of the 3 rounds of due diligence, participants had to decide, whether to continue with the transaction or to withdraw from it (see, Haunschild et al., 1994). Participants in the oppositive reasoning group
were then asked, what aspects within the previously presented due diligence report might cause a change of their initial decision. The participants could then revoke their initial decision regarding the continuation of the transaction. Participants in the disclosive reasoning group had to write a short letter to their assumed shareholders and could then, too, revoke their initial decision. With few exceptions, participants were students from a top tier European Business School. At the time of the study, 57 percent of the participants were at Master’s level or higher.

To complement these findings with richer and more granular processual insights from a variety of organizational contexts we seek to draw on qualitative field data on the decision-making processes in corporate 32 corporate M&A departments. The firms are headquartered in a small European economy and operate in a variety of industries such as consumer goods, services, pharmaceuticals, telecommunication, and banking. So far, we collected external and internal data on M&A processes, tools and checklists and conducted interviews with a total of 67 respondents, with the purpose to understand the decision-making dynamics in the target evaluation process, the adopted processes and perceived challenges. The majority of our informants were C-level executives or heading the Corporate M&A team of their firm and had actively initiated and shaped the M&A processes their firms are using. We are currently in the process of data analysis.

**PRELIMINARY FINDINGS**

“Sometimes they just fall in love with a target. And they are willing to do anything to get it. So, somehow they have to be stopped.” (Head of M&A, pharmaceuticals)

Consistently with Haunschild et al. (1994), the primary variable to measure the effectiveness of the tested debiasing strategies was the number of periods that subjects continued with the due diligence as this represents the manifestation of the overcommitment bias. Figure 1 indicates already the effectiveness of both strategies, as the relative share of participants deciding to continue with the transaction is below the control group fractions in any round of simulated due diligence. Running a two-sample t-test to test for differences in the means of overall decisions to proceed in the transaction process across groups reveals significant evidence for the effectiveness of both strategies in regards of reducing overcommitment in the experimental setup (see table 1) – with more significant results in the oppositive reasoning group.

Analyzing the shareholder letters written by the participants from the disclosive reasoning group with the highest levels of observable overcommitment (not withdrawing at all) reveals remarkable patterns in their ways to make sense of the information in the due diligence reports: Subjects tend to either neglect the negativity of the presented information at all, recognize the negativity but do not attribute much value it, or emphasize the non-negative aspects by considering them as more relevant. Such confirmatory searching behavior is also known from anchoring biases or single-outcome calculation effects. Given that due to the overcommitment, the respective subjects might perceive the conduction of the transaction as the preferable outcome – and having thus, a low propensity to consider information deviating from the already made up opinion – indicates a relationship among these biases.

The preliminary analysis of our qualitative interview data aims to explore the adoption and perceived impediments of the proposed approaches in different organizational contexts.
Opposite reasoning is mostly adopted during target selection processes by M&A departments assessing the financial reasonableness as well as the strategic or organizational fit of the investment opportunities. Here, decision-makers emphasized the importance of considering information that leads to conclusions contrary to an allegedly obvious interpretation: “You force yourself to also look at it from a totally different perspective” (CFO, telecommunications). “We are good at our job because we are so cynical. This is about identifying the negative things, focus on the negative things. Don’t be a happy, cheerful person who is optimistic about everything” (Head of Strategy & Corporate Development, financial services). Respondents from companies, in which the M&A unit is approached by the different business units, that have identified a potential target themselves highlighted the relevance of “spotting red flags, the deal-breakers. We look for these types of signals quite early” (Group Brand Manager, industrial services). “They come to me and say we are interested in something. And the question is: is that actionable or not? Do we validate the interest?” (Head of M&A, pharmaceuticals). Some respondents raised concerns, that when targets are first identified by the executive board and then reviewed by the M&A department, aspects of the opposite argumentation are applied by the members of the M&A team – but not necessarily by the top management responsible for the final decision: “We do an initial assessment for the board of directors, making a statement if there is a fit or not. With a recommendation as to whether it should be pursued. But in the end, the decision is made by the management.” (Manager M&A, construction services)

To examine evidence of disclosive reasoning in our qualitative data, we focused on activities in which M&A decisions are disclosed to a reasonably large group of affected stakeholders. We found various descriptions of internal Steering Committee meetings or external communications, such as shareholder meetings or letters to shareholders from the management in which target selection decisions were explained. Literature suggests, however, contrary influences, such as management hubris (e.g. Hayward & Hambrick, 1997; Hiller & Hambrick, 2005) to be in effect among executive teams faced with strategic decision-making tasks. Thus, we think it is difficult to argue that the debiasing influence of Disclosive Reasoning is observable in internal management meetings. The disclosure of M&A decisions to external stakeholders at shareholder meetings or in letters to the shareholders is a direct application of the disclosive reasoning strategy. We found the explanation behavior of management members in shareholder meetings or notifications to resonate exceptionally well with our findings in the shareholder letters from the participants that revealed the highest levels of overcommitment in the experiment. However, such disclosures are often at a considerably later point in time compared to their corresponding decisions during the transaction. As we don’t know yet, how a time lag between decisions and disclosure of the decisions affects the debiasing impact of the strategy, it is difficult, too, to interpret the shareholder communications as documented manifestations of disclosive reasoning.

**DISCUSSION**

In this ongoing research, we seek to explore the mitigation of overcommitment in the M&A decision-making process. While a branch of psychology research has started to empirically examine a number of debiasing approaches, research on the mitigation of decision-making biases in strategy research still remains rare (for exceptions, see Hodgetkinson & Sparrow, 2002; McNamara, Moon & Bromiley, 2002). In our initial analysis, we found encouraging evidence for the effectiveness of oppositive and disclosive reasoning in M&A contexts. In a next step, we seek to deepen our empirical analysis to exploit the rich contextualizing qualitative data on M&A processes. In this way, we seek to contribute to a better understanding of the adoption of decision-making improving mechanisms in corporate transactions and the associated challenges.
References


