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The Impact of Managers' Self-interested Behavior on the Firm's Strategic Decision-making

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Abstract: Based on agency theory, this paper investigates the impact of managerial self-interest, especially managerial temporal myopia, on corporate strategic decision-making. This myopic behavior can lead to investment myopia, which in turn affects investment decisions. Moreover, it may result in financial distress and stock price crashes, ultimately affecting financing decisions. Firstly, it explores how managers exploit information asymmetry to advance their personal interests, consequently undermining the long-term value of the company. Next, the study examines the specific manifestations and causes of managerial temporal myopia, explaining how short-term behaviors in investment, financing, and debt management affect corporate decision-making. Finally, the paper proposes strategies to mitigate managerial self-interest, including curbing the tendency towards short-term gains, enhancing information disclosure, and restricting managerial expansion without adequate supervision. This analysis aims to provide valuable guidance for corporate governance, helping enterprises to make scientifically sound strategic decisions while considering managerial self-interest. The objective is to avoid long-term losses caused by myopic behavior.

Keywords: Agency theory. Financial distress. Stock price crash. Investment decisions.

1. Introduction

Based on agency theory, this paper investigates the influence of managerial self-interest, especially in terms of managerial temporal myopia, on corporate strategic decision-making. This myopic behavior can lead to investment myopia, subsequently affecting investment decisions. It may also result in financial distress and stock price crashes, thereby impacting financing decisions. These issues ultimately undermine the company's long-term value, impairing its internal operations and potentially eroding its competitive market position and shareholder value. The study aims to examine the specific manifestations of managerial self-interest and explore the mechanisms through which it internally impacts the company. Furthermore, the study suggests countermeasures intended to strengthen corporate governance structures, thus offering a theoretical foundation and guidance for enhancing the quality of corporate strategic decision-making.

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2. Theoretical Foundation

2.1. The Asymmetric Information Theory

The theory of Asymmetric Information is a pivotal concept in economics, delineating scenarios where one party in a transaction possesses superior and more precise knowledge about the transaction object or environment compared to the other. This informational advantage allows the informed party to manipulate the transaction outcome for greater benefits [1]. In the context of publicly traded companies, information asymmetry primarily exists between corporate insiders, usually senior managers, and external investors, primarily shareholders. Insiders hold an unequivocal advantage regarding information about the company's operations. In contrast, external investors are compelled to rely on information disclosed by insiders, placing them at a significant disadvantage regarding the quality, accuracy, and timeliness of the information received. This situation forms the logical foundation for agency theory.

Information asymmetry poses a substantial challenge for shareholders in accurately assessing projects with long-term potential, potentially leading to financing constraints. These constraints may compel management to pass on high-value investment opportunities, resulting in underinvestment [2]. Furthermore, information asymmetry can enable managers to pursue opportunistic investments to expand their business empires, thereby causing overinvestment. During the execution of investment projects, various adverse factors may hinder investment activities from generating anticipated returns. Driven by factors such as compensation, career progression, and promotions, managers might be inclined to disclose only positive information while concealing negative data [3]. This selective disclosure of information can prevent shareholders and the board from promptly identifying and halting managerial investment behaviors driven by self-interest.

Moreover, information asymmetry hinders effective oversight of management by shareholders, necessitating short-term performance-based compensation strategies. This leads management to engage in myopic investment practices and to obscure negative information to meet shareholder performance evaluation criteria, thereby disrupting the company's regular financing processes. In conclusion, the theory of information asymmetry provides a framework for analyzing how managerial self-interest impacts corporate financing risk.

2.2. Agency Theory

In contemporary corporate structures, the bifurcation of ownership and management is a prevalent trend. This bifurcation is facilitated through a series of contractual arrangements wherein company owners, endowed with capital resources, delegate their management authority to professional managers. This act of delegation establishes an agency relationship, positioning shareholders as principals and managers as agents. However, given the assumptions of economic rationality and information asymmetry, this separation invariably gives rise to conflicts of interest [4]. As investors, company owners have the prerogative to claim the residual earnings, which are the net profits remaining after subtracting the costs associated with other production factors. Consequently, their primary objective is to maximize the value of the company. Conversely, managers, as agents, also seek to maximize their personal interests, striving for higher salaries, enhanced reputations, and superior social status [5], all while aiming to achieve these goals with minimal risk. This conflict of interest primarily manifests in two ways.

Firstly, there is a potential divergence of interests between shareholders, who act as principals, and managers, who function as agents. Managers may pursue short-term investment strategies to satisfy shareholder expectations for immediate returns. While these strategies can enhance short-term

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performance, they can also compromise the company's long-term value, thereby affecting shareholder interests and potentially leading to financial risks.

Secondly, managers may prioritize over-investment in areas related to their expertise to secure higher compensation, greater managerial authority, and reduce the risk of replacement [6].

However, this approach may result in the sacrifice of other more valuable investment opportunities.

3. Managerial Self-interest

3.1. Temporal Myopia

Managers, in accordance with actual business conditions, are tasked with making judicious decisions between short-term and long-term interests [7], a responsibility widely acknowledged as paramount. However, due to agency issues, these managers often fail to prioritize the maximization of the company's value by harmonizing short-term and long-term benefits. Instead, they frequently pursue personal interests. In this equilibrium process, there is a pronounced tendency for managers to place excessive emphasis on short-term performance, a condition referred to as temporal myopia. This term denotes the pursuit of personal interests at the expense of the company's long-term value, with the aim of maximizing current financial performance or stock price.

In the realm of investment decisions, this phenomenon manifests as a managerial bias towards projects offering immediate returns, often at the expense of those with delayed payoffs. This preference for short-term investments over long-term ones is evident in various scenarios. For instance, managers might reduce advertising budgets [8], resort to real earnings management to manipulate near-term results [9], or even forgo positive net present value long-term projects to meet immediate earnings targets [10]. Even in an efficient capital market populated by rational actors, temporal myopia can arise if two conditions are met: firstly, when managers prioritize short-term stock price performance during project evaluations; and secondly, when there exists informational asymmetry between managers and investors concerning investment expenditures. External investors, compared to internal ones, often struggle to discern which investments will yield long-term benefits and which won't. Such challenges can lead investors to erroneously attribute short-term underperformance to managerial ineptitude, precipitating a pronounced short-term drop in stock prices. Consequently, when managers exhibit heightened sensitivity to short-term stock movements, they may be disinclined to pursue long-term investments that cannot be clearly validated by investors, thus displaying temporal myopia in their investment strategies.

3.2. Sources of Temporal Myopia

In the realm of investment decision-making, managers often prioritize personal interests. Specifically, to circumvent company takeovers, ensure career stability, and optimize compensation, managers typically adopt behavior that maximizes their benefits. This phenomenon has given rise to mainstream perspectives about managerial temporal myopia, namely the takeover threat hypothesis, the management defense hypothesis, and the compensation distortion hypothesis. The takeover threat hypothesis posits that managers are at risk of losing their compensation and being ousted in the event of a hostile takeover [11]. Consequently, management is more likely to engage in short-term investments to prevent the company's stock price from being undervalued, which could potentially trigger a hostile takeover. The management defense hypothesis suggests that during the retention process, shareholders predominantly assess managers' competencies based on historical investment performance [12]. In an effort to maintain their positions, managers may prioritize short-term operational outcomes over long-term investment strategies. The compensation distortion hypothesis posits that, prior to the market's accurate evaluation of a manager's value, these individuals will inflate the labor market's assessment about their worth [13]. They typically opt for short-term investment

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projects that yield high immediate cash flows, aiming to enhance the company's present value. This strategy misleads the market into attributing the elevated cash flow to the manager's personal capabilities, thereby endorsing their pursuit of increased compensation in subsequent years.

4. Internal Impact of Managerial Self-interest on the Company

4.1. Impact on Investment Decisions: Short-sighted Investment

Initially, managers often prioritize investment projects that yield immediate returns, aiming to enhance short-term performance and stock price. However, they tend to overlook those that could bolster the company's long-term value. Such myopic decision-making may lead companies to forgo projects that, while not profitable in the short term, can yield significant long-term benefits. For instance, technological innovation investments are crucial for enterprises to secure a monopoly position and generate supernormal profits. If managers neglect these investments due to their short-term focus, it can undermine the company's competitiveness and long-term investment returns, thereby elevating financial risks.

Secondly, a problem of information asymmetry arises when managers confront investment expenditures. Internal investors frequently lack essential information and struggle to accurately discern which investment expenditures will yield long-term returns from those that will not. This could prompt investors to inadvertently withdraw investments from projects requiring an extended period to generate returns, potentially precipitating a substantial decline in the company's future stock price. In addition, managers manipulate earnings by reducing actual investment behaviors such as advertising expenses to achieve short-term performance goals. Although this behavior can improve the company's profitability and stock price in the short term, it sacrifices long-term investment returns and corporate value.

Lastly, managers are more inclined to invest in exploitative innovation that builds upon existing technology rather than in exploratory innovation. Exploitative innovation, which does not require extensive technical field expansion and can yield quick investment returns, heightens the risk of corporate inflexibility, potentially compromising future investment performance.

In summary, the self-serving behavior of managers results in biased investment decisions favoring projects with high short-term returns but low long-term returns. This leads to decreased investment in beneficial technological innovations over the long term and manipulation of earnings through actual investment behaviors to achieve short-term objectives. Such actions detrimentally impact the company's ability to create long-term value.

4.2. Impact on Financing Decisions: Financial Distress and Crash Risk

Firstly, the practice of managers prioritizing short-term performance over long-term value significantly increases a company's financial distress risk [14]. This heightened risk can compromise the company's competitiveness, diminish investment returns, and ultimately increase the likelihood of the company being unable to repay its debts when due. As the company's financing risk intensifies, investors will demand a higher rate of return to offset the risks they assume. Consequently, the company may be required to pay higher dividends during equity financing and bear increased interest costs during debt financing. The surge in financing costs will directly augment the company's financial burden.

Secondly, the self-serving behavior of managers may incentivize them to obscure negative news by exaggerating the certainty of a company's earnings. The short cycle of returns from short-term investments and the high level of information transparency during the investment process lead to companies overlooking the potential for a precipitous decline in stock value. This disregard for potential stock price crashes may prompt companies to pursue more aggressive financing strategies

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in the short term. For instance, a company might raise funds by issuing additional stocks when the stock price is at its peak. However, if the market suddenly plummets and investor confidence in the company declines, the plan to issue additional stocks could fail or need to be issued at a substantial discount, thereby increasing financing costs.

In conclusion, the self-serving behavior of managers has significantly impacted a company's financing decisions by increasing financial distress risk and neglecting stock price crash risk. Such actions not only result in increased financing costs for the company, thereby heightening financial burdens, but may also force the company to implement aggressive financing strategies. This, in turn, further exacerbates the company's financial risks and market uncertainties.

5. Advice on Strategic Decision-making of the Company

5.1. Mitigating Short-term Bias

Shareholders ought to foster a greater acceptance of failure and lessen their focus on immediate investment returns. This balanced perspective can alleviate undue pressure on management to chase short-term results. In response, management should leverage government-provided research and development incentives. They must prudently allocate these funds to the company’s long-term ventures, thus bolstering its core competencies and avoiding the pitfall of losing momentum due to a short-sighted approach. For instance, during pivotal phases of strategic transformation and innovative investment, investors might reconsider their expectations for dividend distributions. By doing so, they reduce the company's cash outflows, enabling it to retain more profits for comprehensive planning and investment purposes. Furthermore, shareholders could initiate an R&D strategic investment division within the company, actively securing strategic investments to ensure a steady influx of funds for sustained innovation [15].

5.2. Enhancing Information Disclosure

The challenge of information asymmetry often hinders shareholders from accurately assessing the worth of management's long-term investments. Typically, information about these investments, such as in research and development, tends to be outcome focused. This emphasis can lead to adverse selection, where managers may show limited enthusiasm for long-term ventures and selectively report on their progress. Research and innovation require time to yield results, and companies that do not provide regular updates risk having their silence misinterpreted by shareholders as an indicator of a lack of potential for long-term growth. Consequently, it is counterproductive for managers to adhere strictly to outcome-focused disclosure when communicating interim outcomes of long-term projects to investors. To address this issue, regulatory bodies must establish clear valuation standards and guidelines for disclosing information about the R&D process. By doing so, they can ensure that the true value of long-term corporate investments is communicated to the public in a timely manner, thereby fostering greater managerial commitment to such endeavors [16].

5.3. Curbing Blind Expansion

Managers who concentrate their investments within a specific area can reduce operational risks. However, diversifying into multiple areas may lead to the dispersion of corporate resources, reducing the benefits of focus, and consequently increasing the overall risk level of capital operations [17]. To limit the unchecked expansion of managers' investment behaviors, several measures can be implemented.

Initially, shareholders must define the specific investment domains for the business, considering both the competitive landscape of the enterprise and the developmental stages of various industries.

Managers should avoid hastily venturing into investment ventures in specific sectors due to a lack of comprehensive understanding. Impulsive actions could lead to the underutilization of resources, failing to realize their full potential for value creation.

Secondly, management must prioritize specialization and diversification at the strategic level of the enterprise by establishing relevant strategic departments. These departments are responsible for a comprehensive assessment of the enterprise's actual resource situation, operational management level, and asset quality. They must determine the overall investment level and business scope based on a scientific analysis of current and future cash flow realization situations. This approach aims to prevent investment inflation and excessive business expansion, thus reducing financial distress.

In conclusion, managers must continually explore their areas of expertise and proficiency, embrace technological advancements, and secure competitive edges. This approach should take precedence over the tendency to arbitrarily extend beyond the initial business scope driven by investment desires or trend-following. To keep the enterprise on its established operational trajectory, there is a need to enhance investments in both upstream suppliers and downstream customers, with an emphasis on maintaining stable relationships with key stakeholders. Such an approach can create a resilient supply chain and sustain existing competitive advantages. When entering new industries, it is crucial to carefully assess whether the entry barriers match the enterprise's capabilities, evaluate potential exit strategies, and consider the developmental status and inherent risks of each industry. This vigilance will prevent the scattering of corporate resources, thereby facilitating the attainment of focused advantages.

6. Conclusion

This study extensively examines the influence of managerial myopia, which is propelled by self-centered actions, on the strategic decision-making process of companies using the principal-agent theory as a foundation. The empirical evidence suggests that, in their quest for personal gains, managers frequently prioritize immediate performance metrics at the cost of long-term value creation for their companies. Such short-sightedness not only has the potential to distort investment decisions through short-termism but may also culminate in financial adversities and precipitous stock price declines that affect financing strategies. Prospective research endeavors could broaden the exploration of managerial myopia's multifaceted nature and its subsequent implications for a corporation's strategic policy-making. Beyond mere temporal myopia, future studies ought to contemplate spatially myopic tendencies among managers, characterized by an inclination to allocate resources preferentially to their regions of origin or other known territories. This inclination might be attributed to the manager's personal history, sentimental bonds, or to conventional thought patterns associated with regional loyalty. Future academic inquiries stand to benefit from a more exhaustive evaluation of how variations in managerial behavior across different cultural and geographical milieus can shape corporate strategy selection.

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