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The Moderating Effect of Monitoring on The Relationship Between Adverse Selection and Decision-Making Involving Escalation Situations: An Experimental Study

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Abstract
The streams of research on adverse selection and escalation of commitment are still inconclusive and limited by only manipulating adverse selection in 2 conditions, namely the presence and absence of adverse selection. Meanwhile, the literature shows that adverse selection will always exist in agency contracts even though the information asymmetry mechanism has been modified. This study considers adverse selection manipulation into two levels: high and low. This research investigates the moderating effect of monitoring on the impact of adverse selection and commitment escalation. This research used an experimental method with a 2 x 2 factorial design between subjects. This study involved undergraduate accounting students as extension practitioners. The test results show that different levels of adverse selection impact levels of commitment escalation. The research also indicates that monitoring is quite effective in filtering the impact of adverse selection on commitment escalation behavior.

Keywords
Adverse selection, agency, commitment escalation, experimental, monitoring.

INTRODUCTION

Commitment escalation refers to the decision-making error of continuing a project that shows signs of failure (Narsa & Narsa, 2021; Ridha, 2019; Sari & Rahman, 2022; Sari & Dewanti, 2019). Bintang et al. (2020) explain that commitment escalation is an irrational decision due to a decision-making process that tends to ignore the company's interests and prioritize personal interests. The presence of opportunistic elements in decision-making makes commitment escalation behavior potentially harmful to the organization in the long run (Bone, 2020; Narsa & Narsa, 2021; Wahyudi et al., 2021). The negative impact of commitment escalation behavior has prompted the development of research to examine the factors that cause such behavior.

From the agency perspective, Jensen & Meckling (1976) state that in agency conditions, information asymmetry between the agent and principal can encourage the agent to engage in dysfunctional behavior to optimize personal interests. Rohma (2022) explains that there are two conditions

that explain information asymmetry: moral hazard and adverse selection. A moral hazard is a problem that arises when an agent behaves improperly by not performing activities agreed upon in the employment contract (Rohma & Khoirunnisa, 2024). Such behavior occurs because the principal does not have full information about the activities carried out by the agent. Meanwhile, adverse selection refers to a condition where the principal cannot determine whether a decision made by the agent is based on the information they have acquired or due to negligence (incentive to shirk).

Adverse selection is one of the internal factors that have the potential to cause commitment escalation (Rachmawati & Budianto, 2022; Warliana & Abdullah, 2021) Research development considers adverse selection as the primary cause of commitment escalation (Bintang et al., 2020; Rachmawati & Budianto, 2022; Yani et al., 2019). Several studies have shown that adverse selection impacts the increased occurrence of commitment escalation. In adverse selection situations, individuals tend to escalate commitment to optimize personal interests so that they are not perceived as having failed in project or task execution. However, research developments regarding the relationship between adverse selection and commitment escalation tend to be inconsistent. Some studies indicate that adverse selection influences commitment escalation (Bintang et al., 2020; Narsa & Narsa, 2021; Nasution & Suryawati, 2020; Sa'diyah et al., 2018; Warliana & Abdullah, 2021) On the other hand, other research developments, such as those by Jasrul (2015) and Dwita (2007) have failed to show that adverse selection affects commitment escalation.

The inconsistency in research results may occur due to other phenomena that were not captured in previous studies. Wolk et al. (2016) explain that in agency contracts, the principal will engage in supervisory activities to minimize dysfunctional behavior. Rohma (2022) states that monitoring is one way to minimize dysfunctional behavior. Bintang et al. (2020) explain that monitoring can minimize the occurrence of dysfunctional behavior. Ridhawati et al. (2018) explain that monitoring causes the agent to worry about the risk of their deviations being detected, which tends to reduce commitment escalation behavior. Therefore, the effect of monitoring during the agency contract may explain the inconsistency in the influence of adverse selection on commitment escalation. This study examines the moderating effect of monitoring on the relationship between adverse selection and the tendency for commitment escalation.

This research uses an experimental method with a 2 x 2 factorial between-subjects design. Adverse selection is manipulated into two conditions: high and low. Meanwhile, monitoring is manipulated into two conditions: present and absent. The study involves students as practitioners. The research findings indicate that high adverse selection has the potential to cause greater commitment escalation than low adverse selection. Furthermore, the presence of monitoring is quite effective in mitigating the influence of adverse selection on commitment escalation. These findings contribute to three main streams. First, theoretically, by elaborating on agency theory, this study shows that the relationship between adverse selection and monitoring in agency contracts is an inseparable unit. Second, empirically, this research complements and expands previous research findings regarding the relationship between adverse selection, monitoring, and commitment escalation. Research development is still limited to considering the presence or absence of adverse selection.

Meanwhile, Berg et al. (2009) explain that in agency contracts, there is no condition where adverse selection does not occur, even after modifying information asymmetry within an organization. Therefore, manipulation of the presence or absence of adverse selection may be less relevant. This research expands by manipulating adverse selection into two levels: high and low. Third, the research findings can be used as a consideration for management and regulators in formulating monitoring policies. Evaluation at the end of an activity period needs to be balanced with monitoring during the project to minimize the risk of high adverse selection, which has the potential to cause commitment escalation.

The structure of this paper specifically in the following sections includes a theoretical review and hypothesis development, followed by research methods. The next section covers analysis results and discussion. The final section includes conclusions, research implications, limitations, and suggestions.

LITERATURE REVIEW AND HYPOTHESIS DEVELOPMENT

Agency Theory

Agency theory explains the relationship (contract) between the agent and the principal. The agent is entrusted and authorized by the principal to manage and make decisions on behalf of the

principal (Jensen & Meckling, 1976). The agent has the responsibility to carry out organizational activities that align with the organization's objectives. However, the agent may act in their self-interest, leading to an agency conflict. Agency conflict arises due to information asymmetry (Jensen & Meckling, 1976) in the execution of activities or projects that are among the organization's objectives. The presence of information asymmetry can encourage the agent to behave opportunistically by engaging in commitment escalation (Sari & Rahman, 2022). Commitment escalation is a dysfunctional behavior that can potentially harm the organization in the long run.

Commitment Escalation

Staw (1997) explains that commitment escalation occurs when an individual or organization chooses a course of action to persist, even when there are indications of failure in the ongoing activity. The tendency to continue a failing project can potentially harm the company in the long term (Narsa & Narsa, 2021). From the perspective of agency theory, the tendency of individuals to engage in commitment escalation is driven by personal interests, ignoring the organization's long-term goals. In this study, commitment escalation is proxied by a manager's decision to continue an investment project despite indications of failure.

Adverse Selection

Adverse selection occurs because the agent possesses more information than the principal. Adverse selection is one of the triggers for information asymmetry. Jensen & Meckling (1976) explain that adverse selection is a condition where the principal cannot determine whether a decision made by the agent is based on the information they have acquired or due to negligence (incentive to shirk). The principal's lack of knowledge leads the agent to engage in commitment escalation to optimize their interests, avoiding being perceived as a failure in managing a project undertaken by the organization. Therefore, a strong level of adverse selection is likely to increase the risk of dysfunctional behavior.

Monitoring

Chong & Suryawati (2011) explain that monitoring and monitoring mechanisms within an organization can minimize the tendency for commitment escalation. Individuals who receive monitoring and monitoring are less likely to continue investment projects that are detrimental to the organization (Maulita, 2019; Simbolon, 2020). The practice of monitoring by the principal over the agent can be used as an effort to align goals (Rohma, 2019, 2022; Rohma & Zakiyah, 2022). Aligning the goals between the principal and agent can drive performance improvements and minimize dysfunctional behavior (Kusufi et al., 2020; Rohma & Zakiyah, 2022; Rohma et al., 2023). Thus, monitoring during project execution can restrict the manager's scope to engage in commitment escalation behavior due to periodic reviews during the project.

Adverse Selection and Commitment Escalation

From the perspective of agency theory, information asymmetry can encourage individuals to engage in dysfunctional behavior (Jensen & Meckling, 1976). Differences in information give the agent more leeway to engage in activities that optimize their interests (Rohma, 2022; Wolk et al., 2016). Adverse selection occurs in situations of information asymmetry, making it difficult for the principal to monitor and control the agent's actions (Rachmawati & Budianto, 2022). The agency theory perspective strengthens the explanation that adverse selection encourages individuals to escalate their commitment to eliminate negative perceptions and avoid the stigma of failure due to their inability to manage and execute a project. Research development has shown that adverse selection influences the tendency for commitment escalation (Narsa & Narsa, 2021; Rosana & Handoko, 2021; Sari & Wirakusuma, 2016; Warliana & Abdullah, 2021). High adverse selection creates a greater opportunity for the agent to behave opportunistically than low adverse selection. Thus, a high level of adverse selection will likely lead the agent to engage in greater commitment escalation to maintain their reputation, even though such actions could harm the organization in the long run. Therefore, the research hypothesis proposed is:

> H1: The tendency for commitment escalation behavior is likely greater under high adverse selection conditions than under low adverse selection conditions.

Monitoring and Commitment Escalation

Jensen & Meckling (1976) explain that from the agency theory perspective, the principal will attempt to implement monitoring to minimize agency conflicts. The monitoring costs incurred by the principal will be charged to the company as monitoring expenses, potentially reducing the company's net profit, which could decrease the agent's compensation (Wolk et al., 2016). Therefore, to avoid a reduction in compensation, the agent will strive to behave in alignment with the company's goals so that the principal will minimize monitoring expenses (Rohma, 2019, 2021; Wolk et al., 2016). Monitoring involves the observation of the manager's efforts or the results achieved through monitoring, financial monitoring, and other mechanisms (Chong & Suryawati, 2011; Kusufi et al., 2020). Monitoring is conducted to align personal and organizational interests to prevent dysfunctional behavior and enhance goal alignment (Kusufi et al., 2020). Chong & Suryawati (2011), Chulkov & Barron (2021), Maulita (2019) and Prihatini (2021) have shown that monitoring influences commitment escalation. Monitoring during activity implementation may provide the principal with more information about the ongoing activities. As a result, the agent's potential to engage in commitment escalation becomes smaller because the principal has sufficient knowledge about the ongoing activities. Therefore, the hypothesis proposed in this study is:

H2: The tendency for commitment escalation behavior is likely smaller under conditions of monitoring than under conditions without monitoring.

Adverse Selection, Monitoring, and Commitment Escalation

Jensen & Meckling (1976) explain that in agency contracts, information asymmetry encourages the agent to optimize their interests. Adverse selection, which causes information asymmetry, drives individuals to escalate their commitment to protect their reputation, ignoring the benefits to the organization. Some studies have shown that adverse selection encourages commitment escalation (Apriwandi et al., 2021; Bintang et al., 2020; Narsa & Narsa, 2021). Adverse selection provides an opportunity for the agent to optimize their interests, leading to greater monetary compensation (Rohma, 2022). However, Wolk et al. (2016) explain that in agency contracts, the principal will implement monitoring to minimize the agent's dysfunctional behavior. Monitoring activities can minimize the risk of fraud (Nahartyo et al., 2020; Rohma, 2022). Prihatini (2021) and Ridhawati et al. (2018) found that monitoring can minimize the tendency for commitment escalation. Therefore, under conditions of adverse selection, which allows for commitment escalation, monitoring may encourage individuals to avoid the risk of being detected for deviant behavior by minimizing commitment escalation. Thus, the hypothesis proposed in this study is:

H3: Monitoring moderates the effect of adverse selection on commitment escalation.

RESEARCH METHOD

Research Design

This study employs a laboratory experiment method using a 2 x 2 factorial between-subjects design. Nahartyo and Utami (2016) explain that the experimental method has a significant advantage over other methods in testing the cause-and-effect relationship between independent and dependent variables, as supported by robust theories. This study elaborates on agency theory to explain the relationship between adverse selection, monitoring, and commitment escalation. The adverse selection variable is manipulated into two treatments: high and low. Meanwhile, the monitoring variable is manipulated into two treatments: present and absent. The experimental design is presented in Table 1.

Table 1. Experimental Design

TREATMENT		Adverse Selection	
		High	Low
Monitoring	Present	Cell 1	Cell 3
	Absent	Cell 2	Cell 4

Source: Processed data, 2023

Participants

The participants in this study are undergraduate accounting students who have completed courses in financial management and management accounting, serving as proxies for practitioners. These students, having taken the courses, possess a sufficient understanding of concepts, case analysis, and assignments related to capital budgeting and performance evaluation. The selection of students as participants is based on several reasons. First, Narsa & Narsa, (2021) state that final-year students have an adequate understanding of capital budgeting. Second, the literature has shown that undergraduate accounting students who have completed management accounting courses can be considered knowledgeable about budgeting and the common issues that arise during budget preparation (Sampouw, 2018). Thus, using students is expected to minimize the occurrence of social desirability bias due to the experience effect present in practitioners.

Before the main experiment, a pilot test was conducted on the research instruments and manipulations. This study carried out two pilot tests using subjects with qualifications equivalent to those of the subjects in the main experiment. The pilot test results indicated that the manipulations were well-internalized by the participants. Participants involved in the pilot test were not included in the main experiment to minimize bias. The total number of participants for each cell or group was not less than 10 participants (Nahartyo, 2012). This study involved 75 participants, with an average of 14-15 participants per cell, who were randomly selected.

Operational Definitions and Variable Measurement

The dependent variable in this study is the individual's tendency to engage in commitment escalation. Commitment escalation is proxied by the individual's decision preference to either continue or terminate an unprofitable project, using a 10-point scale divided at the midpoint between 5 and 6. Choices 1-5 indicate a decision to terminate the project, with numbers closer to one indicating greater certainty in not continuing the project. Conversely, choices 6-10 indicate a decision to continue the project, with numbers closer to 10 indicating greater certainty in continuing the project (Ang & Cheng, 2016). Participants were placed in the role of junior project managers.

The independent variable in this study is adverse selection, which was manipulated into two conditions: high and low. In the high adverse selection condition, participants received information about the poor performance of the project, which was known only to the project manager and would not be disclosed to others inside or outside the company. In the low adverse selection condition, participants were given information about poor project performance that was known by project managers of equal level within the company, but not by senior managers or others outside the company.

The moderating variable in this study is monitoring, which was manipulated into two conditions: the presence of monitoring and the absence of monitoring. In the presence of monitoring conditions, participants were informed that monitoring and evaluation would be conducted once the project reached 50% completion. In the absence of monitoring condition, participants were informed that monitoring and evaluation would be carried out at the end of the project.

Manipulation Checks and Data Analysis Techniques

There are three manipulation check questions provided to assess the participants' internalization of the case and manipulations. The first manipulation check question relates to the participants' position in the project assignment. The second and third manipulation check questions pertain to the manipulated variables, namely the conditions of the adverse selection variable and the monitoring variable. Participants were asked to select the statement that best represented the conditions they encountered in the case material. Participants were required to answer all three questions correctly. Those who failed to answer any of the manipulation check questions were excluded from hypothesis testing, as they were deemed unable to internalize the instruments and manipulations adequately. This study employed a Two-Way ANOVA for hypothesis testing. Before testing the hypotheses, the data were analyzed using two assumption tests: residual normality and homogeneity of variance.

RESULTS AND DISCUSSION

Demographic Characteristics

The total number of participants in this study was 72. However, 8 participants did not completely fill out the demographic information, and 5 participants failed to correctly answer the manipulation check questions. As a result, the data from 59 participants were usable for hypothesis testing.

The demographic characteristics of the participants are presented in Table 2. The analysis in Table 2 shows that out of the 59 participants, 12 (or 20.33%) were male, and 47 (or 79.33%) were female. The analysis also shows that 6 participants (or 10.17%) were aged ≤ 20, while 53 participants (or 89.83%) were aged between 21-25 years. Table 2 indicates that 28 participants (or 47.46%) had a Cumulative Grade Point Average (CGPA) between 3.00-3.50 (on a 4.00 scale), while 31 participants (or 52.54%) had a CGPA between 3.51-4.00 (on a 4.00 scale).

Table 2. Demographic Characteristics

Variable		N	Percentage
Gender	Male	12	20.33%
	Female	47	79.33%
Age	≤ 20	6	10.17%
	20-25	53	89.83%
CGPA	3.00-3.50	28	47.46%
	3.50-4.00	31	52.54%

Source: Processed data, 2023

Hypothesis Testing Results

The hypothesis testing in this study was conducted using a two-way ANOVA, which requires the fulfilment of two assumptions before the hypothesis testing can be carried out. The first assumption is residual normality, which was tested using the Kolmogorov-Smirnov Test, and the second is homogeneity of variance, which was tested using Levene's Test. The two-way ANVA test is performed to identify differences between each treatment group and the interaction between variables, where each variable has more than one treatment manipulation. As explained by Gudono (2014), ANOVA is the best analytical tool for testing differences between treatments of a single variable.

The results of the normality test, presented in Table 3, show a p-value > 0.725. These results indicate that the residual data are normally distributed, meaning there are no issues with residual normality. The second assumption is the homogeneity of variances, which was tested using Levene's test. The results of the homogeneity test, also presented in Table 3, show a p-value > 0.195. This analysis indicates that there are no issues with variance homogeneity. Since the assumptions of residual normality and homogeneity of variances are met, the ANOVA test could proceed. The hypothesis testing was conducted using a two-way ANOVA, and the results are presented in Table 4.

Table 3. Assumption Test

Test	*p-value*
Kolmogorov-Smirnov Test	0.725
Levene's Test	0.195

Source: Processed data, 2023

Table 4. Hypothesis Testing

Dependent Variable: Commitment Escalation			
Variable	**F**	**Sig.**	**Marginal Means**
Adverse Selection	2.552	0.006	High: 4.000 Low: 3.500
Monitoring	3.175	0.002	Present: 3.733 Absent: 4.607
Adverse Selection*Monitoring	2.862	0.004	

Source: Processed data, 2023

The first hypothesis predicts that escalation of commitment behavior is likely to be higher under conditions of high adverse selection compared to low adverse selection. The analysis results in Table 4 indicate that adverse selection influences the escalation of commitment behavior, with F = 2.552; p<0.006. The estimated marginal means show that the tendency for escalation of commitment is higher under high adverse selection conditions, with a value of 4.000, compared to low adverse selection conditions, where the average escalation of commitment is 3.500. These results in Table 4 indicate that hypothesis 1 is supported.

The second hypothesis predicts that escalation of commitment behavior is likely to be higher when there is no monitoring compared to when there is monitoring. The analysis results in Table 4

show that monitoring affects the escalation of commitment behavior, with F = 3.175; p<0.002. The estimated marginal means indicate that the tendency for escalation of commitment is higher when there is no monitoring, with a value of 4.607, compared to when there is monitoring, where the value is 3.733. These results in Table 4 indicate that hypothesis 2 is supported.

The third hypothesis predicts that there is an interaction between monitoring and adverse selection on escalation of commitment behavior, with F= 5.862; p<0.004. The analysis results show an interaction between adverse selection and monitoring on escalation of commitment behavior. The presence of adverse selection encourages individuals to escalate their commitment. However, the tendency for individuals to engage in adverse selection will likely differ due to the presence of monitoring, which increases the likelihood of detecting deviations during the supervisory process. Therefore, hypothesis 3 is supported.

Discussions

The analysis shows that escalation of commitment behavior tends to be greater in conditions of high adverse selection compared to low adverse selection. This finding aligns with the agency theory perspective, which suggests that information asymmetry can lead individuals to behave opportunistically (Jensen & Meckling, 1976). Agents who possess more information have opportunities to make decisions that personally benefit them, with the principal being unaware of the true situation. The presence of adverse selection, arising from information imbalance, gives individuals the chance to escalate commitment to avoid being perceived as having poor performance. This study's findings also support previous research that shows adverse selection influences the tendency to escalate commitment (Bintang et al., 2020; Nasution & Suryawati, 2020; Prihatini, 2021; Ridha, 2019; Sari & Rahman, 2022; Yani et al., 2019). Narsa & Narsa (2021) also demonstrated that the tendency to escalate commitment is higher in conditions of adverse selection compared to when adverse selection is absent. However, Berg et al. (2009) explain that information asymmetry and incentives to shirk will always exist within organizations, even if the organization modifies assignments and activities. Therefore, the complete absence of adverse selection is highly unlikely; rather, differences in the level of adverse selection may affect escalation of commitment behavior. The higher the level of adverse selection, the greater the potential for opportunistic behavior, which can lead to higher levels of escalation of commitment in high adverse selection scenarios compared to low ones.

The analysis shows that escalation of commitment behavior tends to be lower when there is monitoring compared to when there is none. This finding is consistent with Wolk et al. (2016), who explained that in agency contracts, principals will seek to reduce the potential for dysfunctional behavior by implementing monitoring. This finding also aligns with research showing that monitoring affects the escalation of commitment (Bone, 2020; Maulita, 2019; Ridhawati et al., 2018). Additionally, Chong & Suryawati (2011) explained that control in the form of monitoring by the principal can reduce the tendency for opportunistic behavior, such as escalation of commitment. Monitoring by the principal reduces the agent's opportunity to escalate commitment because the risk of deviations being detected increases with monitoring.

The results of the analysis indicate the presence of an interaction effect between adverse selection and monitoring concerning the escalation of commitment. This finding is consistent with the agency theory perspective that information asymmetry in agency contracts leads agents to behave opportunistically (Jensen & Meckling, 1976). Meanwhile, to prevent opportunistic behavior in agency contracts, the principal will attempt to implement monitoring (Jensen & Meckling, 1976). Thus, adverse selection conditions provide opportunities for agents to escalate commitment. However, the presence of monitoring reduces the chances of adverse selection because the risk of potential deviations being detected becomes greater.

Additionally, Wolk et al. (2016) explain that the monitoring costs incurred in an agency contract will be borne by the company, which could lead to increased expenses and decreased net profit for the company. A decrease in net profit could potentially result in a reduction in the compensation provided to the agent (Rohma, 2019). Therefore, monitoring may encourage agents to minimize the escalation of commitment behavior, as monitoring entails costs that will ultimately be borne by the organization, potentially reducing the compensation received. Consequently, agents will be more likely to align their behavior with the company's objectives by minimizing escalation of commitment to reduce monitoring costs, thereby maintaining their monetary compensation.

CONCLUSION

This study shows that different levels of adverse selection have a significant impact on varying levels of escalation of commitment. Monitoring can be used as a strategy to mitigate escalation of commitment behavior. Furthermore, the findings of this study indicate that monitoring can minimize the impact of adverse selection on the escalation of commitment. These findings have several implications. First, this study expands on previous research by considering the effect of different levels of adverse selection on the escalation of commitment behavior. Second, the findings can be used by management and regulators as a consideration that evaluations conducted at the end of a project or assignment should be accompanied by a monitoring mechanism (midway through the project or task) as part of an integrated and comprehensive evaluation system.

This study has some limitations. First, it only considers the internal factors of individuals without including moral and ethical values inherent in everyone's personality. Second, this study uses a laboratory experiment method, so readers should be cautious in generalizing from the findings. Therefore, future research is suggested to explore internal aspects inherent in individuals, such as morality, ethics, and psychological capital, including spirituality and religiosity.

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