A dual process framework (Chaiken and Trope 1999) was used to investigate the effects of corporate fraud on individual investment decisions. Two experiments suggest that corporate fraud led to a broad defensive bias towards stock investments in a second-party firm due to generalized suspicion. In addition, the prior reputation of the second-party firm did little to buffer the effects of generalized suspicion. Process measures indicated that the generalized effects of fraud occurred automatically, through biased heuristic processing. Overall, the findings were consistent with defensive processing, and suggest that investment fraud can cause investors to become irrationally suspicious.

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EXTENDED ABSTRACT

Recent frauds by Enron, Worldcom, and Tyco have had a devastating effect on the stock prices of the firms directly involved. More interesting is that these frauds seemed to have much broader effects on the stocks of companies not directly involved in the scandals. For instance, news of Tyco’s fraud met with a broad sell-off in the domestic stock markets (McKay 2002), and Worldcom’s troubles precipitated a 4% drop in stock in international markets (Economist 2002). We examined generalized suspicion as a possible mechanism for the negative impact of fraud on stock investment. The information processing induced by such suspicions was also investigated.

Dual process theory (Chaiken and Trope 1999) proposes that judgment occurs through two qualitatively different types of information processing: 1) heuristic processing, a relatively automatic form of judgment relying on simple heuristic cues, and 2) systematic processing, which involves careful thought and integration of information when making judgments. Information processing can be motivated by a number of different goals, including accuracy and defense concerns (Chen and Chaiken 1999). Accuracy goals motivate individuals to make valid, correct, or objective judgments, whereas defense goals lead to judgments aimed at maintaining self-esteem or protecting material interests.

Prior research in the trust literature (Rotter 1971) makes a distinction between specific trust/distrust based on past experiences with the same information source (e.g., distrust of Enron following revelation of the fraud this firm committed), and generalized trust/distrust based on experiences with other, similar sources of information (e.g., distrust of other firms on the basis of Enron’s misdeeds). Previous research (Petty et al. 1983) shows that specific trust can act as a simple agreement heuristic (e.g., “I should agree with the financial statements of firms that I already know and trust”), whereas specific distrust tends to increase the amount of systematic information processing that occurs, thereby improving the accuracy of judgment (Priester and Petty 1995). In contrast, generalized trust/suspicion tends to be schema-based or stereotyped, where judgments occur automatically in response to associations between the information source and trusted/distrusted groups or organizations (Kramer 1999). Consistent with this mechanism, prior research examining consumer reactions to false advertising shows that deception by one firm can automatically evoke the negative stereotype that no firms can be trusted, resulting in more negative attitudes towards unrelated second-party firms (Darke and Ritchie 2003).

Two experiments examined the prediction that fraudulent statements made by one firm would produce more negative investment decisions towards a second, unrelated firm due to generalized suspicion. The basic strategy was to expose participants to false financial statements from one firm (deception manipulation), and then examine the implications for information processing, suspicion and investment decisions towards a second, unrelated firm. The findings of both studies supported our predictions by showing that corporate deception lowered investor confidence as well as the amount of money invested in the second firm. Process analyses indicated that these effects occurred because the initial fraud induced greater distrust of the second firm. Moreover, these effects occurred automatically, in that they were not mediated by conscious thoughts about the second firm. Other evidence argued against negative affect as an alternative explanation for the effects of fraud on investment.

In addition, both experiments also manipulated the level of the specific trust concerning the prior reputation of the second-party firm, in order to examine whether specific trust would be effective in buffering firms from the negative effects of generalized suspicion. Accuracy-based views of trust/suspicion suggest it is reasonable to generalize suspicion from one source to another only when more diagnostic information about the trustworthiness of the second source is not available (Rotter 1971). However, other evidence suggests that individuals are not always perfectly rational when it comes to distrust (Kramer 1998). Suspicions can be exaggerated, and may be maintained despite specific information suggesting a particular source is trustworthy. Consistent with the bias view, the results of both experiments showed that specific trust did little to buffer the second-party firm from the effects of generalized suspicion. These findings fit the view that suspicion evoked a defensive bias in judgment, where investors who have been fooled once become wary of additional financial claims in order to avoid being fooled again.

Our research is consistent with the idea that corporate fraud undermines investor trust in a general sense. Generalized suspicions also proved capable of undermining reputable second-party firms, not just lesser known firms. These findings underscore the need for publically traded firms to be concerned about investment fraud, and the need to better regulate the accounting and finance industries to reduce the likelihood of similar events in the future. As suggested by Robert Shiller (2003), trust may be “[t]he market’s most valuable stock.”

REFERENCES