Editorial

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Traditionally, financial economists have based their work on the standard assumption that agents are fully rational, self-interested, maximisers of expected utility (the homo economicus view). However, scholars are increasingly recognising that the psychological biases of investors, managers and other relevant actors may affect decision-making and outcomes in financial markets and in corporations. As a result, a new body of research, behavioural finance, has emerged as a challenge to the traditional paradigm.

Behavioural finance focuses on the effects of investor biases on the behaviour of financial markets. In parallel, other areas have emerged. Behavioural Corporate Finance examines the effects of managerial psychological biases on corporate finance decisions (such as investment appraisal, capital structure, dividend policy, and mergers and acquisitions). Behavioural accounting considers the effects of managerial biases on accounting and reporting issues. Behavioural finance, behavioural corporate finance, and behavioural accounting will be the focus of future issues of this journal.

In this inaugural issue, we focus on another interesting research area; behavioural corporate governance. This body of work considers the psychological biases affecting key players in the governance of corporations, such as boards of directors, auditors, regulators, and governments. In particular, behavioural corporate governance seeks to understand how governance mechanisms may affect agency problems in the presence of such biases. The five papers herein provide a microcosm of the research approach to behavioural corporate governance, finance and accounting, since they cover theoretical, conceptual, experimental, and econometric analyses.

In the first paper in this issue, ‘Behaviour and Rationality in Corporate Governance’, Marnet provides an overview of existing research in behavioural corporate governance. In particular, he focuses on the research into the effects of psychological biases of the board of directors and external auditors on the performance of corporate governance mechanisms. In doing so, Marnet integrates various strands of the literature on corporate governance, cognitive research, and behavioural economics to shed light on questions regarding the independence of boards of directors and external auditors.

The rational-actor model is seen as an important tool to analyse the expected behaviour of individuals and groups, and it provides many useful insights into human decision making. It should nevertheless be recognised that actors frequently make judgments based on their cognitive apparatus (with all its limitations), emotive state, and within social and situational contexts, which makes real choice behaviour far messier and more complicated than models of optimal choice behaviour typically acknowledge. Auditors and board directors are, for example, no less subject to the common human preference for immediate gratification than other individuals, typically with insufficient regard for negative future consequences of present actions. The magnitude of such negative outcomes tends to be discounted and possibly further reduced in perceived severity and probability by self-serving justifications and over-optimism.

In the second paper, Fairchild provides a game-theoretic analysis of the relationship between auditor tenure, managerial fraud and report qualification. In terms of behavioural issues, he focuses on the effect of tenure on empathetic feelings between the auditor and the client. Fairchild analyses two conflicting effects resulting from an increase in auditor tenure:

1 a 'learning curve' effect (increasing tenure increases auditor ability to detect fraud)

2 a 'loss of independence' effect (increasing tenure results in an increasing closeness, or empathy, between auditor and client, which may lead the auditor to 'turn a blind eye' to fraud).

Fairchild's model contributes to the ongoing international debate on auditor tenure and mandatory auditor turnover. Furthermore, he considers ethical issues relating to the audit process.

Following Marnet's review paper of behavioural corporate governance, and Fairchild's game-theoretic approach to auditor independence, the third paper in this issue (by Spieth et al.) provides a conceptual framework for understanding the behavioural issues involved in succession planning in German family businesses.

Business succession planning, the transfer of management functions and ownership to one or more family members, gained significantly in importance over the last few years. Spieth et al analyse the subject from a behavioural perspective aiming to evaluate the characteristics of family business succession planning. Spieth et al.'s investigation demonstrates how their concept of family business governance can be used as a management tool of successful company succession in small and medium-sized companies, and also provides suggestions how the recommendations of the German Governance Code can be applied to family businesses.

Hence, the first three papers are theoretic/conceptual. To provide a balance, the final two papers provide an empirical exploration into behavioural aspects of corporate governance. In the penultimate paper, Butler conducts an experiment to consider the interaction of framing biases, long-term compensation plans, and risky choices.

The problem of determining how to use salary and bonuses to influence managers' decision making incentives continues to be at the focus of the corporate governance discussion. Butler's study examines the effect of long-term compensation plans on risky choice behaviour. The experiments indicate that risky choices will vary depending on the coding of the outcomes. Specifically, it is shown that participants were risk seeking when presented with the possibility of losses, but risk averse for gains. One result shows that the introduction of a long-term compensation plan may cause agents to make less risk averse choices.

The final paper employs econometric analysis to test the relationship between board structure and CSR in Malaysia. Lim et al.'s paper discusses the behavioural factors contributing to a firm's incentives to invest in corporate social responsibility. The study also aims to examine the difference of CSR disclosure level between government-linked companies and non-government linked companies. Further examined is the question whether corporate governance initiatives among Malaysian public listed companies have succeeded in improving levels of CSR disclosure. The paper helps to reduce the gap in the literature particularly on the relationship between CSR disclosure and corporate governance initiatives in the Malaysian context.

It is hoped that the balanced theoretical and empirical approach in this issue will provide an inspiration for future research that may find its way into future issues of this journal.