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Overconfidence Behavioral Bias in Working Capital Management and Performance of Small and Medium Enterprise in Ghana: A Conceptual Paper

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Abstract

The concept of overconfidence is well understood in financial market and corporate decision as individual investors and managers of large corporations prone to overconfident bias. This paper is the first to conceptualize overconfidence bias in working capital management and performance of Small and medium enterprise by employing qualitative case study inquiry to gain insight and small and medium enterprise (SME) managers overconfident behavioral. This paper argues that overconfidence bias can distort working capital investment with the possibility of overinvestment working capital inventory if SME managers have enough internal equity in anticipation of higher performance.

Keywords: overconfidence small and medium enterprise, working capital management, performance

Introduction

Small and medium enterprises (SMEs) are globally recognized as the engine of socio-economic transformation, growth and sustainable development through job creation and contribution to GDP. SMEs contributions largely depend on their financial performance directly influenced by how they manage working capital, which is their short-term investment portfolio of net current assets.

As most SME managers are not well conversant with the standard working capital management operations, they manage working capital subjectively based on their experience and preference (Filbeck & Lee, 2000) by relying on their experience and preference (Pham, 2013; Bandara & Rathnasiri, 2016). Yet traditionalist, in the fully glary of these stylized facts, still conceptualize firm and industry characteristics, market factors determinants of WCM (Palombini & Nakamura, 2012; Baños-Caballero et al., 2014).

Even though subjective decisions distort working capital management and may expose SME managers to overconfidence bias, it has not been given proper attention so we are not informed on overconfidence bias proper application in working capital management and performance.

Fortunately, overconfidence bias tends to influence individual investors decision on the financial market, top executive's corporate policies and many others (Ben-David et al., 2010; Kent & Hirshleifer, 2015). Because overconfident people believe to have superior abilities and skills, underweight the likelihood of their failure and overly trust in accuracy of their decisions, they perceive

themselves to better their peers and thus expect their performance to be above industry average (Weinstein, 1980; Cooper et al., 1988).

Since performance triggers overconfidence in managers, it appears relevant to all especially SMEs managers concern about maximizing their welfare. SME managers in Ghana hardly follow formal working capital management so consider their experiences and interest as framework working capital decisions. Although managers have unique personal traits, emotional and cognitive abilities that influence working capital management and performance, those with exceptional abilities and experiences to identify viable opportunities seem to be highly optimistic about their success than their colleagues, thereby increasing their working capital investment in order to realize expected higher performance, thinking that their operating cash flows or sales revenue is more stable or certain than they expected and be committed to their course of action. Hence, the intent of this paper is to provide conceptual understanding of overconfident bias in working capital management and performance of SME due to their influence on the society and industry (Marsidi, 2020).

Literature Review

Overconfidence Bias

A plethora of studies point that people make systematic errors in economic decision. Since rationality is bounded, people are prone to cognitive biases or emotional biases (Simon, 1965). The feelings of illusion of control, better than average effect and excessive optimism induce people to be overconfident (Weinstein, 1980; Langer, 1975; Svenson, 1981; Cooper et al., 1988). Overconfidence is overestimation of abilities and skills, precision of knowledge and information and ability to control future events. A manager under this bias overestimate their firm performance and overly optimistic about outcome financial decisions they control (Malmendier, Tate & Yan, 2011). Because they believe that can create more value for their firm, they tend to overinvest by overestimating the cash flow to their projects they personally chose (Malmendier and Tate, 2015).

Overconfident CEOs invest more in mergers and acquisition, capital expenditure and R&D (Malmendier & Tate, 2008; Galasso & Simcoe, 2011, Chen & Lin 2013; Panpan & Xindong, 2017) if they have sufficient internal cash. Eichholtz and Yonder (2015) established that overconfident CEOs in the real estate industry buy more assets and sell less of them if they have plenty “discretionary cash”. Meanwhile, when overconfident CFOs use lower discount rate, they overestimate their returns to their long-term asset and overinvest substantially in long term (Ben-David, Graham & Harvey, 2007).

Overconfidence also distort the information asymmetric between the lenders and firm. Overconfident managers rich in internal funds is more likely overinvest in capital projects than non-overconfident managers with same levels of funds. But when the internal funds are or cash flow is not enough, overconfident manager will curtail investment (Malmendier & Tate 2015). As managers dislike to finance their project with external capital due costly debt and fear dilution in the equity holdings.

Meanwhile, overconfident CFOs use less equity and more debt to finance projects when the financial deficit of the firm is high (Malmendier, Tate & Yan, 2011). However, Yung et al. (2015) proved that overconfident CEOs use more debt financing than equity and increases cash to assets ratio leads to a decline in financial performance. In addition, Barros and Silveira (2008) indicates that optimistic managers maintain higher debt ratio in the firm’s capital structure, which tend to financial cost of their firms and the likelihood of financial distress.

Alternatively, when overconfident investors perceive their private information to be more accurate than the market information, they overtrade believing that they can outperform market mean returns (Kent & Hirshleifer, 2015). But the expected returns were lower for such investors who are too overconfident and excessively overinvested than those who made moderate investment.

In term performance, Schoar and Bertrand (2003) aggressive managers produce higher return on investment than conservative managers. Moreover, mild overconfidence managers posted higher return on investment while highly overconfidence CEO who had a lower return due to excessive overinvestment. In contrast, RIET CEO Overconfidence produce negative returns (Eichholtz and Yönder, 2015) and underestimation risk results in lower performance (Hackbarth, 2008).

Working Capital Management

Working capital management is famous *short-term* decision for every firm, particularly SMEs because their investments are current asset, mainly financed by short-term credit. The concern of WCM is how much to invest in inventory, accounts payable and accounts receivable to create value to sustain daily operations.

Most studies support the view that SME should lower investment in working capital due to financing constraints (Pais & Gama, 2013; Lamptey et al., 2017). Others papers argues SMEs should maintain optimal by applying working capital framework such as the Economic Order quantity (EOQ), cash model and others since they directly contributes to both operating liquidity and performance in order to set off the costs and benefits associated with over and under investment working capital maximize high returns. In doing so, SME can avoid the risk of stock out and possibility of failure due excessive financing costs. Filbeck and Lee (2000) found that SME do not apply working capital models. Managers who tried applying were not properly implemented due lack of knowledge and lack of ability (Muchaendepi et al., 2019).

Alternatively, several factors have been found to influence consisting of several internal factors (firms factors) such firm age, operating cash flows, debt and others and external factors (economic variables) such GDP, inflation to determine the reasonable level working capital a firm should maintain consistent with operations (Palombini & Nakamura, 2012).

In Ghana (2012) indicates although SME manager are familiar cash budgeting and inventory they are not formalized and such decisions based on the manager's daily operations. Other studies find that most SMEs cannot determine the optimal amount of cash to hold due to lack of proper cash management policy (Kwame, 2007; Hamza et al., 2015). In addition, about 87 % SMEs determine cash balance based on the owner/manager's experience and administrators own knowledge and information (Agyei-Mensah, 2012; Donkor, 2015). Moreover, SMEs have weak trade receivables management practices (Agyei-Mensah, 2012).

These evidences suggest that indicate that managers experience is more important than application of theories of both inventory and cash balances in majority of the SMEs (Donkor, 2015). In conclusion, SMEs in Ghana hardly follow standard working capital management practice

SME Performance

Performance is the overall goal of firms to maximize shareholder equity. Small and medium enterprises performance show how managers have efficiently managed their working capital investment to create more value increase owner's wealth. In addition, the performance also enhances the SME competitiveness, attractiveness, growth and its overall contribution to gross domestic products (GDP).

Although there are several factors contributing to this performance, working capital exerts significant influence since it directly contributes to SME performance. The general consensus is that lower investment in working capital increases performance substantial than higher investment in working capital given SME constraint to obtain long-term capital and high cost of borrowing associated overinvestment in current asset.

Figure 1: Proposed overconfidence framework for WCM and performance

The intent of this framework is help SME managers to improve their performance the overconfidence framework will develop the understanding of SME managers and their implications and how to moderate their biasness in WCM.

Conclusion

This conceptual paper shows the influence of overconfidence bias on working capital management and performance of SMEs. We conclude that SME managers' overconfidence behavioral bias is very essential to working capital management and performance since they do not apply theories while making working capital decisions. This paper is the first to the conceptualize overconfidence bias in working capital management and performance. Thus, we provide new insight on overconfident SMEs managers for study working capital management. Our framework extends the concept of managerial overconfident which focuses on individual investors and corporate managers of corporations. Again, we make new contributions to concept of overconfident based the application of this framework of overconfident bias by demonstrating that overconfident SME can influence working capital management and performance. This means the application of this framework will be relevant to SMEs managers who wish to improve performance, especially SME managers in Ghana who might consider overconfidence as alternative framework to better enhance working capital management and performance than applying models. The conceptual framework guide policy makers, small business analyst to develop policies and programs to improve the SME manager's financial management administration, as well as behavioral financial decision making as new paradigm. The framework provides insight to managers on proper application of how their behavioral biases can negatively or positively impact working capital management and performance. Overall, our framework is a novelty and can contribute to higher performance of SME conditional that internal capital is sufficient for biased managers to overinvest in working capital by moderating their overconfidence.

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