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BEHAVIORAL FINANCE AND ITS IMPACT ON POOR FINANCIAL PERFORMANCE OF SMES: A REVIEW

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ABSTRACT

Decision making is a rational process. It will be irrational to claim that there would be no biases in rational decision-making process. Investment decisions are no exception to this. It is common that Behavioral elements in the investment decision are ignored either in stock market or in the working capital or capital budgeting decision by SMEs. This paper aims to study the different components of Behavioral finance that will impact the poor financial performance of Small and Medium size Enterprises (SMEs). The research is based on prevailing literature on behavioral finance and SMEs. The authors have made an attempt to use the available literature relevant to Behavioral finance, poor financial performance of SMEs and behavioral biases in investment decisions. After reviewing the various research papers, the authors have identified that behavioral components have a direct or indirect impact on the financial decision of SMEs which in turn affects the performance of SMEs.

Keywords: Behavioral finance, SMEs, investment decisions, poor decision making.

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1. INTRODUCTION

As quoted by the economist, "Finance is defined as the study of how scare resources are allocated by humans, and how these resources are managed (working capital decision), acquired (capital structure decision) and invested (capital budgeting decision) over time". The traditional finance theories were framed based on a premise of rationality. It is assumed that all the market agents are rational. The economist presumed that market agents interpret the newly available information and make the market efficient. The Efficient Market Hypothesis (EMH) is one of the important contributions to the field of finance. EMH helps in understanding the financial market and market agents. (Shiller, 2003) pointed out that, around 1970's EMH theory had become more prevalent in academic circles. However, these theories failed in understanding the human behavior associated with the investment decision process. Therefore, the new discipline called Behavioral Finance was found which combines psychology and finance. According to (Ricciardi & Simon, 2000), "Behavioral Finance is a study that attempts to explain and enhance the understanding of the reasoning patterns of investors, which includes the emotional processes and the extent to which they influence the investment decision-making process." From the above literature it is evident that behavioral finance attempts to explain the finance and investment, from human behavior perspective.

Behavioral finance theories are more focused in understanding the cognitive, social and emotional biases of investors and to analyze how these biases influence the market prices, returns, and allocation of resources. Therefore, Behavioral finance is a contemporary discipline that applies the theories of the psychology to understand the behavior of investors and financial markets.

Today's right decision will decide tomorrow's success. Choosing the right alternative that fits the situation is the crux of the decision making. Financial decision making is backed up with different behavioral biases and therefore it becomes very important for the decision maker to understand the behavioral biases and make decisions prudently. Large companies can withstand a wrong investment decision since they have large financial reserves to sustain. But for the SMEs, one wrong financial decision puts its future survival at stake. Finance managers of SMEs have to take a short term financial decision like investment in working capital and long term investment decisions like capital budgeting. Thus financial managers of SMEs should be more careful and aware of behavioral attributes which impacts on investment decision process.

2. NEED FOR THE STUDY

Decision making in large organizations are a planned process supported by data analytics, but small and medium enterprises cannot afford to invest in recruiting experts to analyze data. Lack of access to the latest technology in data analytics, the financial decisions in SMEs are based on the manager's experience and personal judgment. The decision makers in SMEs are influenced by different behavioral biases like herd behavior, anchoring, overconfidence, self-attribution bias and so on. It was found in the study that.

Entrepreneurs of SMEs are found to be usually overconfident while taking the financial decisions (Simon Gervais, November, 2009). The authors have identified the gap to link between the poor financial performance and the behavioral aspects of investment decisions related to SMEs.

3. OBJECTIVES OF THE STUDY

- To identify the behavioral biases that influences the financial decision making of SMEs.
- To identify the reasons for poor financial performance of SMEs.

4. REVIEW OF LITERATURE

4.1. Review of literature related to behavioral finance

Rational and irrational decisions made by individuals depend on personality traits, cognitive bias and heuristics. Personality constructs namely risk taking, self-awareness, locus of control and self-awareness will significantly influence investment decisions. Even the emotions and moods of a person whether pleasant or unpleasant would influence the decision making process. Distorted thinking like self-talk, memory devils/anger and drawing inappropriate and misleading comparison of investment schemes influence the decision making. Goals of the investors would decide investor's behavior (Mathews, 2013).

According to (Athur, 2014), the individual investors investment decisions are correlated with the behavioral biases like 'Overconfidence'; 'Representativeness'; 'Herding'; 'Anchoring'; 'Cognitive Dissonance'; 'Regret Aversion'; 'Gamblers' Fallacy'; 'Mental Accounting' 'Prospect Theory'; 'Hindsight Bias' and many other heuristic biases.

Awareness about the biases may not avoid losses but will help in minimizing the losses. Long term investment will smoothen the short-term fluctuations of the market. Portfolio planning should be part of the successful investment decision. Emotional control is essential when markets are highly volatile, therefore investor should not take irrational decisions and make the market even more volatile (Suresh, 2013).

EMH was proved based on the premise of rationality, but none of the economist could explain few questions like: 'why markets outperform or underperform?' 'Why do individual investors trade?', 'why do returns vary across stocks for reasons other than risk?' Therefore, to answer these questions, a new discipline called behavioral finance was introduced, which mainly studies the human behavior involved in investment decisions.

After studying different reviews which supports rationality and irrationality of decision making in stock market, the researchers conducted a survey to find out that most of the times irrational behavior exists in decision making. It was evident from the study that investment decision making is influenced by financial astrologer advice, panicking behavior due to bad news and self-attribution bias which the claim for success is due to their knowledge and analysis and failure is attributed to bad luck (Kapse & Mamta Keswani, 2010).

Individual decision making are highly influenced by the intuitions and heuristics. The different heuristics which influence decision making include availability heuristics, representativeness heuristics, anchoring heuristics and affect heuristics. Decision making is also influenced by various biases like confidence and optimum bias, confirmation bias and herding effect (Halaba & Ali Coskun, 2016).

Capital budgeting decisions are taken by the managers in small and medium firms. They tend to take decision with little or no data about the future outcomes. In this decision process it is evident that managers tend to be overconfident about the outcomes. Over confidence is the key trait that differentiates between managers of SMEs and large organizations.

In large organizations, there will be a well-defined procedure framed by the experts for making capital budgeting decision which is uncommon among small and medium firms. Because of overconfidence, they overdo the investment and overestimate the future cash inflows and discounts the future cash inflows with lower cost of capital and get into trouble in future (Simon Gervais, November, 2009).

Daniel Kahneman and Amos Tversky (1979) introduced the concept of framing. They identified few psychological principles that govern the perception of decision problems. It was found that evaluation of probabilities and outcomes produced predictable shifts of preference when the same problem is framed in different ways.

Abhijeet Chandra (2008) studied the behavioral factors and psychology which influences their decision making. They found that investors are not always rational and their investment decisions are influenced to a greater extent by behavioral factors like greed and fear, cognitive dissonance, heuristics, mental accounting, and anchoring. The other finding of their research was that investors display risk-seeking behavior and avoid selling stocks when faced with loss. Investors segregate their investments into separate mental accounts created to meet a specific investment objective. There is suggestive evidence that these emotional and behavioral factors need to be incorporated in the investment strategies formulated for individual investors. Investors while taking investment decisions must consider these biases as a risk factor associated with their investment portfolios.

Misal D M (2013) opines that the irrational behavior of investors could be attributed to two major mistakes of investors which lead into irrationality. Firstly overconfidence resulting in excessive trading and Secondly, the tendency of holding a losing investment as a result of regret aversion.

Dr Vikram (2013) in his paper "Applying Behavioral Finance by analyzing investors' behavior in Lucknow city" opines that investors analyze the market sentiments before investing and after active participation in investment they are addicted to market analysis which ends in excessive trading. He also found that investors become optimistic at the time of loss and that anchoring plays an important role in decision making as investors rely more on new information and adjust their decisions.

Dr Mahabaleshwara Bhatt H S (2010) studied the trading behavior of investors during the period 1998- 2008. He found that there was a remarkable shift from rationality to irrationality as there were middle income group and lower middle income group people who entered the market by investing their small saving expecting huge profits without even analyzing the risk associated with the investment. And further he investigated whether Indian investors were in investment trap.

Daiva Jurevincience, Olga Ivanova (2013) conducted a research survey among literate Lithuanian households to find the importance of behavioral finance theories in household decision making and the dependency between behavioral factor and financial decisions. They found that some characteristics (such as the winner's curse effect or loss aversion) are similar to those established by scientists of behavioral economics and some characteristics (absence of the market impact) are unique. They also found that when investors are faced with uncertainty, investor behavior becomes irrational depending on the degree of risk.

Rahul Subash, (2012) aims to find the influence of certain identified behavioral finance concepts (or biases), namely, Overconfidence, Representativeness, Herding, Anchoring, Cognitive Dissonance, Regret Aversion, Gamblers' Fallacy, Mental Accounting, and Hindsight Bias, on the decision making process of individual investors categorized into young investors and experienced investors in the Indian Stock Market. His study reveals that the degree of exposure to the biases separated the behavioral pattern of young and experienced investors. Gamblers' Fallacy, Anchoring and Hindsight biases were seen to affect the young investors significantly more than experienced investors.

4.2. Review of literature related to poor financial performance of SMEs

Success and failure have equal chance to happen in any business. In this study, both critical factors for success and failures have been discussed. The success factors include service to the customer, know-how of the business and leadership of the manager (which depends upon the experience). Lack of access to financial capital and inadequate infrastructure and government policies are the critical factors for failure (Naqvi).

(Jonisiu Ndinomwene Kambwale, Clever Chisoro, & Anis Mahomed Karodia, 2015) conclude that major reasons for failure of SMEs are inappropriate financial management, poor planning, lack of capital and access to find and insufficient training and education. From the survey, they have identified that poor financial support and lack of managerial skills are the reasons for the poor performance of SMEs.

(Fatoki, 2014) points out that the high failure rate of business would slow down the economic growth and employment rate. He classified two reasons for failure namely; internal reasons which include lack of management experience, lack of functional skills and staff training and negative attitude towards the customers. The external reasons they include lack of finance and non-availability of logistics and rising costs of doing business. There is a need for training for managers on investment decision.

(Kalane, 2015) identified various reasons for failure of SMEs in South Africa which includes

Lack of control over cash flows and lack of knowledge of financial decision making skills, poor cash flow management, high competition, poor working capital management and infighting among the partners, lack of managerial skills and lack of planning, poor credit management and inappropriate use of business funds.

(Vijayakumar & G Rajendra, 2015) found that many SMEs had few teething problems in setting up the business, and finally they had to liquidate the business at the infancy stage of business only. The various reasons for failure include financial, operational and managerial issues.

(Hoque, 2017) It was observed that own savings and loan from friends and relatives is the primary source of financing and micro credit is the secondary source of financing. The interesting points to note that earning from the existing business were used to meet family expenditures. So it is evident that mental accounting bias is having significant influence on the financial management of SMEs.

(Ahmad, 2009) Lack of research before making an investment is one of the behavioral biases associated with business failure. Misinterpretation of market demand, locating the office at wrong place, inability to find suitable business partners and inability to select reliable suppliers are some of the reasons for business failures.

(Giardino, Wangm, & Abraham, 2014) in their study "Why Early Stage Software Fail: a Behavioral Approach", did in-depth analysis of reasons of failure of sprawling businesses. They classified the journey of the companies into two stages i.e. early (actual) and behavioral. They found that many companies fail at behavioral stage which requires being dynamic in decision making at turbulent situations. And they concluded by stating that inconsistent decision making strategies is the major reason for failure.

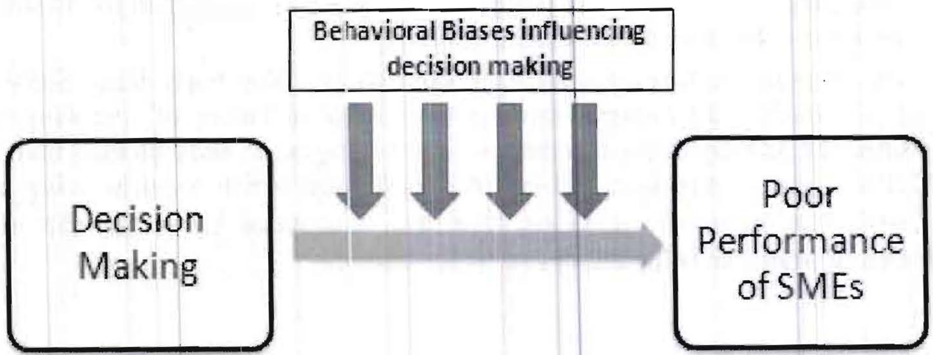
Table 1 Linking the literature relating to behavioral biases and poor performance of SMEs.

Authors	Behavioral component of decision making	Authors	Reasons for sickness
Suresh	Emotional control	Jonisiu Ndinomwene Kambwale, Clever Chisoro, & Anis Mahomed Karodia	Inappropriate financial decision making, poor planning, lack of decision making skills
Kapse & Mamta Keswani and Dr Mahebaleshwara Bhatt HS and Daiva Jurevinciene, Olga Ivanova	Irrationality of decision making	Fatoki, 2014	lack of management experience, lack of functional skills, lack of finance and non-availability of logistic
Halaba & Ali Coskun	Heuristics	Kalane, 2015	Lack of knowledge of financial decision making skills, poor cash flow management, high competition, poor working capital management
Simon Gervais and Rahul Subash and Misal D M	Overconfidence	Vijayakumar & G Rajendra,	Financial, operational and managerial
Daniel Kahneman and Amos Tversky	Perception of decision problems	Ahmad, 2009	Lack of research before making an investment is one of the behavioral elements associated with business failure. Misinterpretation of market, locating the office at wrong place, inability to find suitable business partners
Abhijeet Chandra And Rahul Subash and Dr Vikram	Behavioral factors like greed and fear, cognitive dissonance and optimistic toward loss	Giardino, Wangm, & Abraham	Inconsistent decision making strategies

5. CONCEPTUAL FRAMEWORK

A conceptual framework have been developed in order to explain how behavioral biases influence the decision making process leading to poor performance of SMEs. It was evident from the above literature review that decision making skills of managers like expertise in a specific domain, problem solving skills, conflict handling etc in SMEs have a direct impact on the performance of SMEs (Fatoki, 2014).

Table 2 A conceptual framework indicating how behavioral biases influence decision making leading to poor performance



6. DISCUSSION AND CONCLUSION

With an expected growth of $ 5 trillion Indian economy by 2025, the major focus has been diverted towards strengthening the SME sector leading to job creation, boosting entrepreneurship adding to the GDP. By realizing the significance of SMEs contribution to the GDP, the Honorable Prime Minister of India, Shri. Narendra Modi has introduced many schemes like Public Procurement Policy, Pradhan Mantri MUDRA Yojana, and Make in India, Startup India, and Skill India to uplift the SMEs. However, the growth rate of SMEs is as low as 8% which indicates that there is a gap in the performance. The authors have attempted to study the reasons behind the gap in performance and were able to point out the behavioral problems involved in decision making as one of the major constraint to be addressed. The other reasons for the poor performance of SMEs include poor managerial skills, poor working capital decision, inappropriate utilization of funds, lack of availability of funds on time, inability to find suitable business partners, inability to select reliable suppliers, fail to market the product, lack of government support, poor credit management, poor business decision, lack of training on managerial skills, high competition, inappropriate location of the plant, over confidence in decision making and insufficient infrastructure and lack of leadership skills.

To have sustainable growths of SMEs, authors have suggests to impart special training programmes to the Personnel involved in decision making. This will enable the Personnel to gain knowledge about the different behavioral biases involved in decision making and be more cautious while taking key decisions in the organization. This in turn leads to the betterment of SMEs.

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