Faculty of Economics and Business

Working Capital Management of Small and Medium-Sized Enterprises (SMEs) in Accra, Ghana: The Perspective of Owner Managers' Behavioral Biases

Jeff Lamptey

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Jeff Lamptey

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DECLARATION

I declare that the work in this thesis was carried out in accordance with the regulations of Universiti Malaysia Sarawak. Except where due acknowledgements have been made, the work is that of the author alone. The thesis has not been accepted for any degree and is not concurrently submitted in candidature of any other degree.

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Signature

Name: Jeff Lamptey

Matric No.: 16010170

Faculty of Economics and Business

Universiti Malaysia Sarawak

Date:

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ABSTRACT

This thesis aims to investigate the working capital management of Small and Medium-Sized Enterprises (SMEs) in Accra, Ghana from the perspective of owner managers' behavioral biases. Knowledge about behavioral biases in working capital management has lagged despite the fact that most Small and Medium Enterprises (SMEs) managers who employed a subjective approach to working capital management may expose themselves to overconfidence, Loss aversion, anchoring, and adjustment biases. To address this concern, this thesis employed qualitative designs and obtained textual data through telephone interviews with thirty-five (35) SME owner-managers to obtain their perspective on these biases by exploring the basic assumptions of overconfidence theories (Better- than average effect; the illusion of control and excessive optimism and over the precision of knowledge), Loss aversion theory and anchoring and adjustment theory. Based on the thematic data analysis, this study finds support that SMEs owner-managers exhibit overconfidence, loss aversion, anchoring, and adjustment, influencing working capital management. Specifically, the results suggest that overconfident SME owner-managers believe that they possess superior financial ability, perfect industry knowledge and are optimistic about business success and wish to overinvest in working capital inventory if they have enough internal funds. Furthermore, the finding suggested that loss-averse SME owner-managers exhibited the fear of loss and costs disposition effects to the extent that highly loss-averse SMEs owner managers tend to underinvest in working capital inventory while low loss-averse SMEs managers tend to overinvest in working capital inventory. In terms of anchoring and adjustment bias, the results show that managers rely heavily on mental shortcuts or heuristics: self-generated and provided anchors in working capital management. More specifically, SME owner-managers rely on customer trust, initial offers (price list, quotation), and market trends and demand (past and current sales). The premium managers attached to these anchors led them to either overinvest or underinvest in working capital. Specifically, low anchor (low initial offers and high growth market) tends to induce managers to increase working capital investment inventories while high anchor (high initial offer and declined market growth) discouraged SMEs managers to curtail working capital investment. Meanwhile, managers tend to grant more accounts receivable to highly trusted customers because of longstanding business relationships, taken as low default risk, than customers with a short-term business relationship. The study findings contribute by adding to the limited empirical evidence that exists on the influence of SMEs owner-manager overconfidence and inventory management, cash management, financing; SMEs owner managers' loss aversion and inventory management and anchoring and adjustment bias of SMEs owner-managers, and inventory management, accounts receivable. By implication, the findings of this study support the theories of overconfidence, loss aversion theory, anchoring, and adjustment and add to broaden the scope of working management practices in SMEs. Finally, the study concludes that SMEs managers' behavioral biases matter in working capital management.

Keywords: Anchoring and Adjustment Bias, overconfidence, Loss Aversion Bias, Working Capital Management, SMEs owner managers.

Pengurusan Modal Kerja Perusahaan Kecil dan Sederhana (PKS) di Accra, Ghana: Perspektif Bias Tingkah Laku Pengurus Pemilik

ABSTRAK

Tesis ini bertujuan untuk menyiasat pengurusan modal kerja Perusahaan Kecil dan Sederhana (PKS) di Accra, Ghana dari perspektif bias tingkah laku pengurus pemilik. Pengetahuan tentang kecondongan tingkah laku dalam pengurusan modal kerja telah ketinggalan walaupun kebanyakan pengurus Perusahaan Kecil dan Sederhana (PKS) yang menggunakan pendekatan subjektif terhadap pengurusan modal kerja mungkin mendedahkan diri mereka kepada terlalu yakin, mengelak kerugian, berlabuh dan berat sebelah pelarasan. Untuk menangani kebimbangan ini, tesis ini menggunakan reka bentuk kualitatif dan memperoleh data teks melalui temu bual telefon dengan tiga puluh lima (35) pengurus pemilik PKS untuk mendapatkan perspektif mereka tentang berat sebelah ini dengan meneroka andaian asas teori terlalu yakin (Lebih baik daripada kesan purata; ilusi kawalan dan keyakinan yang berlebihan dan ke atas ketepatan pengetahuan), teori keengganan kerugian dan teori penambat dan pelarasan. Berdasarkan analisis data tematik, kajian ini mendapat sokongan bahawa pemilik-pengurus PKS menunjukkan terlalu yakin, mengelak kerugian, berlabuh, dan pelarasan, mempengaruhi pengurusan modal kerja. Secara khususnya, keputusan menunjukkan bahawa pengurus-pengurus PKS yang terlalu yakin bahawa mereka memiliki keupayaan kewangan yang unggul, pengetahuan industri yang sempurna dan optimis tentang kejayaan perniagaan dan ingin melabur secara berlebihan dalam inventori modal kerja jika mereka mempunyai dana dalaman yang mencukupi. Tambahan pula, penemuan mencadangkan bahawa pemilik-pengurus PKS yang elak kerugian mempamerkan ketakutan terhadap kerugian dan kesan pelupusan kos sehingga ke tahap pengurus pemilik PKS yang mengelak kerugian cenderung untuk kurang

melabur dalam inventori modal kerja manakala pengurus PKS yang mengelak kerugian yang rendah cenderung untuk terlebih melabur. dalam inventori modal kerja. Dari segi kecenderungan berlabuh dan pelarasan, keputusan menunjukkan bahawa pengurus sangat bergantung pada pintasan mental atau heuristik: sauh yang dijana sendiri dan disediakan dalam pengurusan modal kerja. Lebih khusus lagi, pengurus pemilik PKS bergantung pada kepercayaan pelanggan, tawaran awal (senarai harga, sebut harga), dan arah aliran dan permintaan pasaran (jualan masa lalu dan semasa). Pengurus premium yang melekat pada sauh ini menyebabkan mereka sama ada terlebih melabur atau kurang melabur dalam modal kerja. Khususnya, sauh rendah (tawaran awal yang rendah dan pasaran pertumbuhan tinggi) cenderung mendorong pengurus untuk meningkatkan inventori pelaburan modal kerja manakala sauh yang tinggi (tawaran awal yang tinggi dan pertumbuhan pasaran yang merosot) tidak menggalakkan pengurus PKS untuk mengurangkan pelaburan modal kerja. Sementara itu, pengurus cenderung untuk memberikan lebih banyak akaun belum terima kepada pelanggan yang sangat dipercayai kerana hubungan perniagaan yang telah lama terjalin, diambil sebagai risiko lalai yang rendah, berbanding pelanggan yang mempunyai hubungan perniagaan jangka pendek. Penemuan kajian menyumbang dengan menambah kepada bukti empirikal terhad yang wujud terhadap pengaruh keyakinan berlebihan pengurus-pengurus PKS dan pengurusan inventori, pengurusan tunai, pembiayaan; Keengganan pengurus pemilik PKS dan pengurusan inventori serta penambat dan berat sebelah pelarasan pengurus pemilik PKS, dan pengurusan inventori, akaun belum terima. Secara implikasinya, dapatan kajian ini menyokong teori terlalu yakin, teori penghindaran kerugian, berlabuh, dan pelarasan serta menambah meluaskan skop amalan pengurusan kerja dalam PKS. Akhir sekali, kajian menyimpulkan bahawa berat sebelah tingkah laku pengurus PKS penting dalam pengurusan modal kerja.

Kata kunci: *Bias Berlabuh dan Pelarasan, keyakinan terlalu, Kecondongan Kerugian, Pengurusan Modal Kerja, pengurus pemilik PKS.*

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LIST OF ABBREVIATIONS

CAPM	Capital Asset Pricing Model
CEO	Chief Executive Officer
CFO	Chief Financial Officer
EOQ	Economic Order Quantity
EPQ	Economic Production Quantity
EPS	Earnings Per Share
ERP	Enterprise Resources Planning
EU	European Union
EUT	Expected Utility Theory
GDP	Gross Domestic Product
GHS	Ghana Cedis
JIT	Just –In-Time
MRP	Material Resources Planning
MSMEs	Micro, Small and Medium Enterprise
OECD	Organisation for Economic Cooperation and Development
ROI	Return on Investment
SME	Small and Medium –Sized Enterprise
WCM	Capital Asset Pricing Model

CHAPTER 1

INTRODUCTION

1.1 Introduction

Working capital management is a financial decision concerning current asset and current liabilities to support daily operation of the firm (Banos-Caballero et al., 2014; Onalopo et al., 2015). Small and Medium Enterprises (SMEs) managers are highly expected to manage working capital efficiently to create value for their firms. In doing this, they decide how much to invest in cash, inventories; receivables, and how much credit is needed to finance current assets (Baños-Caballero et al., 2010; Elbadry, 2018) while ensuring proper planning, control, and monitoring of the levels of working capital investment.

Such decisions enable SMEs to prioritize investment in cash, inventories, receivables, and financing needs for transactional, speculative, and precautionary purposes to maintain an appropriate level of investment in current assets for daily operations. Whether the decision is to buy inventories on either cash or credit, sell on either cash or credit to customers, or some other working capital management decisions, managers are expected to follow the standard finance practice for optimal solutions (Baumol, 1952).

Unfortunately, most managers lack knowledge of the standard financial practices and thus adopt a subjective approach to the working capital decisions (Filbeck & Lee, 2000; Howorth & Westhead, 2003; Khoury et al., 1999). For this reason, SMEs regard owner managers' experience and personal attributes to be more important in making working capital decisions to attain their expected results than using theories (Agyei -Mensah, 2012; Bandara & Rathnasiri, 2016).

However, the social psychology and behavioral finance literature indicate that the domain of subjective decision extends beyond personal attributes to psychological factors: cognitive and emotional factors. The cognitive and emotional-based decision-making may lead to systematic errors or biases including overconfidence bias, anchoring and adjustment bias, loss aversion bias and mental accounting, confirmation bias, and others (Malmendier & Tate, 2011, 2015; Pompian, 2012; Tversky & Kahneman, 1974).

Some scholarly works show that individual investors and managers of large corporations make investment and financing decisions based on their behavioral biases to maximize corporate performance (Malmendier & Tate, 2018). The most widely explored behavioral biases included overconfidence, loss aversion, and anchoring bias (Heaton, 2002; Malmendier & Tate, 2015; Tversky & Kahneman, 1974), which are relevant to this study. However, there is a lack of knowledge of how SME managers susceptible to such behavioural biases manage working capital because past studies have overlooked their significance (Lyngstadaas & Berg, 2016; Tran et al., 2017).

Therefore, the purpose of this research is to investigate how SME owner-managers are prone to behavioral biases (e.g., overconfidence, loss aversion, and anchoring and adjustment biases) manage the working capital of SMEs and contribute to theory, empirical, and practice.

1.2 Background of the Study

There is a growing research interest in behavioral biases. The psychology and behavioral corporate finance literature suggest people make subjective financial decisions (Liu & Jiang, 2012) based on how they actually behave or think (Ackerts & Davis, 2010; Pompian, 2012) and not how they should act or behave as suggested by the standard traditional finance paradigms anchored on the concept of rational individual and rational market.

Psychologists argue that people are not perfect or entirely rational in the decision-making process since rationality is bounded (Simon, 1955, 1956). Simon (1955, p.312) pointed out that the "human mind is not like a computer that can be programmed to process and perform all complex optimization processes" such as the Capital Asset Pricing Model (CAPM) (Sharpe, 1964, 1965; Lintner, 1965) Portfolio Theory (Markowitz, 1952) and others, which postulate what "Rational man", or "Efficient Market" is. Moreover, decision-making is time-bound, and individuals are incapable to gather all relevant information before making the final decision.

In this case, when people face complex financial decision-making problems that demand substantial time and cognitive ability, they have difficulty following a rational approach established for analyzing a proper course of action. Instead, they usually adopt a more subjective approach of reasoning to determine the course of action consistent with their desired outcome or preference. In doing so, they may be biased in the decision-making process. These biases may lead to irrational managerial behaviors and distort the outcomes of the decision (Maharani & Witiastuti, 2015; Pompian, 2012). In other words, individuals naturally deviate from the standard finance theories devised for optimal solutions and systematically favor certain outcomes over others based on their intuition, beliefs, or preference. Consequently, irrational behaviors may result in bias or irrational financial decisions due to either "faulty cognitive reasoning" or "reasoning influenced by emotions or feelings" or both (Pompian, 2012).

Cognitive biases come from either faulty cognitive reasoning or cognitive errors, which include Illusion of Control bias, anchoring and adjustment bias and others. This tendency arises when an individual cannot accurately interpret data, process information, or cannot follow the complex mathematical procedure applied (Pompian, 2012) to find, say, the economic order quantity (EOQ), or appraise a customer's creditworthiness, and apply cash models. However, an individual decision-maker understands his processes of making financial decisions to achieve desired results. Moreover, an individual will suffer from emotional biases when his judgment is clouded by his beliefs, intuition, attitudes, and feelings (Birknerová et al., 2017; Graham, et al., 2013) because such emotions stem overconfidence, regret aversion bias, loss aversion bias, and many others (Clarke & Statman, 2000; Tversky & Kahneman, 1974, 1979).

In each case, emotional biases or cognitive biases can distort rational financial decisions and affect the expected outcomes or gains (Tversky & Kahneman, 1974). So, insight into how behavioral biases induce managers in the financial decision-making process is particularly important for SMEs due to their dependence on managers' characteristics to make a decision (Åstebro et al., 2014; Zhang & Cueto, 2017).

Nonetheless, by comparison, the cognitive decision making of SMEs managers has lagged as compared to top corporate managers who have been observed to systematically exhibit symptoms of overconfidence, loss aversion, anchoring bias in investment decisions (Malmendier & Tate, 2015; Rostami, & Dehaghani, 2015). Thus, these behavioral tendencies are relevant to the context of the study.

1.2.1 Managerial Behavioural: Overconfident Bias

The general assertion that decision-makers can be overconfident is central in cognitive psychology and behavioral finance literature. The hubris of overconfidence largely stems from how people think or assess their abilities, private information, and the outcome of a future event from a reference point (i.e., Benchmark)(Malmendier & Tate, 2015; Weinstein, 1980).

This intuition makes individuals overconfident and considers themselves better than others (Langer, 1975; Malmendier & Tate, 2015; Svenson, 1981). Consequently, such people expect only favorable outcomes from their decision without considering the expected future failure. This is because such people believe that they have total control of the outcomes of future events (Langer, 1975; Weinstein, 1980). So, these indiividual mostly expect their actions or decisions to bring better results or success to justify their claim of being better. Therefore, overconfident people tend to attribute good things to their actions or abilities but blame others for poor results or attribute their failure to bad omen (Miller & Ross, 1975).

Overconfident people exist in every profession (Bazerman, 1990; Lichtenstein & Fischhoff, 1977). In medicine, for example, overconfidence has been identified as the root cause of diagnostic mistakes in which over 35% of diagnostic errors over the past five years were caused by some overconfident physicians (Berner et al., 2008). Overconfident coaches have been instrumental due to their immense contributions to the National League teams (Zavertiaeva et al., 2018). Even college professors show their confidence in their abilities as 94% believed themselves to do “above average” work (Cross, 1977). Moreover, Svenson