A THEORETICAL CONTRIBUTION OF SME MANAGER'S OVERCONFIDENCE BIAS IN WORKING CAPITAL MANAGEMENT AND PERFORMANCE

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ABSTRACT

We argue that managerial overconfidence bias affects working capital management. Overconfident SME managers overestimate their sales growth and underestimate the volatility of cash flow of their firms and thus overinvest in inventory for higher returns if they have enough personal capital or cheaper sources of external capital. An overconfident SME manager will overinvest because of the transactional motive, market signaling effect and market leadership motive. We describe SME managers as overconfident if the person claims to have superior financial ability, perfect industry knowledge and is optimistic in business and thus systematically fail to reduce their personal exposures (maximization wealth) to their firms' specific risks. Thus, overconfidence can serve as useful framework for most SME managers who make working capital decisions, particularly inventory based on their personal characteristics.

Keywords: SME, Overconfidence, Working Capital Management, Inventory Management, Theoretical Contribution

INTRODUCTION

Working capital management and performance are of great concern to Small and Medium Enterprises (SMEs). The traditional finance suggests that corporate entities follow models to make financial decision for optimal solutions. Whether the decision is about cash, inventory, receivable or any other short-term decisions, SMEs are required to apply the standard working capital practices or models to maximise returns on investment. In particular, it is assumed that applying the Economic Order Quantity (EOQ) and other inventory models will result in optimal investment in working capital in the area of inventory by trading off the costs and benefits to maximise expected performance (Deloof, 2002; Ross et al., 2010). On the contrary, Khoury, et al., (1999); Howorth & West head (2003) assert that most SMEs adopt ad-hoc or subjective approach to working capital management. Consistent with this argument, Filbeck & Lee (2000) disclose that SMEs rarely use working capital models.

Following these assertions, the main finding from few empirical studies is that SMEs lack knowledge of standard working capital management practices and do not follow theories in managing working capital (Pieterson, 2012; Donkor, 2015; Bandara & Rathnasiri, 2016). Instead, they rely on manager's experience and personal attributes to make inventory decisions to attain the desired performance (Marfo-Yiadom, 2000; Agyei-Mensah, 2012; Kusi et al., 2015; Bandara & Rathnasiri, 2016).

To the extent that SMEs largely depend on a manager's experience and personal attributes, they may highly regard these personality traits as a useful framework for working capital decision. This may suggest that such managers have exceptional financial abilities and other qualities that distinguishes them from their peers in the industry. Yet, modern finance has failed to offer any plausible explanation for a better appreciation of managers' behavior in inventory management.