İşletme Araştırmaları Dergisi
ISSN: 1309 - 0712

İşletme Araştırmaları Dergisi
Journal of Business Research-Turk
10/3 (2018) 80-94

Journal Of
Business Research
Turk
www.isarder.org

Corporate Finance Decisions from the Perspective of Behavioral Finance Theory

Meltem Gürünlü
İstanbul Arel University
Faculty of Economics and Administrative Sciences
Department of International Trade and Finance
İstanbul, Turkey
orcid.org/000-0001-6790-4256
meltemgurunlu@arel.edu.tr

Extensive Summary

Introduction

This paper aims to survey the literature on corporate finance from the perspective of behavioral finance theory. Corporate finance deals with the decisions made by managers and investors and their effects on firm value or stock price. Traditionally, corporate finance assumes that both groups have fully rational behaviors and hence stocks are always fairly priced. Investors may think that managers are not acting according to their own interests. In this case, the investors will have to offer some executive compensation schemes to parallel the benefits of the managers with their own benefits. However, in a real world, it seems that both managers and investors can not act rationally. “Behavioral Corporate finance” claims that systematic behaviors and prejudices affect decision-making processes of both groups. As both corporate executives managing the companies and investors investing in these companies are not completely rational, it is possible that both parties can make serial mistakes based on their behavioral biases. “Behavioral Corporate Finance” approach which is a comparatively new area in behavioral finance involves explaining managerial decisions as well as investors by taking into account psychological factors related to human behaviors. This study aims to summarize research on behavioral corporate finance and give some recommendations so that both managers and investors can make mutually successful decisions.

In general, we can divide approaches in Behavioral Corporate Finance. The first of these approaches tries to explain the non-rational decisions made by managers who make their decisions under the assumption that financial markets are fully efficient. The second approach, on the contrary, considers rational managers' decisions in financial markets which works inefficiently. Such an analysis takes into account the cases where investors behave irrationally in a systematic manner and managers are fully rational and

Gönderme Tarihi 15 Haziran 2018; Revizyon Tarihi 26 Temmuz 2018; Kabul Tarihi 1 Ağustos 2018

M. Gürünlü 10/3 (2018) 80-94

have the perfect information. “Behavioral Corporate Finance” is able to explain many observations and instances that classical corporate finance approach is unable to explain.

Methodology

As the methodology, an in-depth literature survey was conducted.

Findings & Discussion

It is possible that both corporate executives and investors investing in these companies can make mistakes because it is not possible to be completely rational. This study summarizes the research on behavioral corporate finance and some proposals are made so that both managers and investors can make mutually successful decisions.

How can systematic errors stemming from behaviors be prevented? Above all, it is impossible to be away from the prejudices that cause mistakes while making decisions. Individuals can learn these prejudices and psychological tendencies, but this spreads for a very long time. Managers can make good investment and financing decisions for the well-being of the investors. If investors can understand that managers act on behalf of the investors, they can choose talented managers and provide effective interest aligning mechanisms. If such mechanisms are established to parallelize both parties’ interests, it will be possible for managers to make value-enhancing decisions. Thus, mutual benefit of the parties may be possible.

For reasons related to price stability, managers frequently buy back company shares to increase demand. Such a motive does not say anything about whether or not repurchases create value, or whether it will destroy the value. Investors should also be skeptical of the managers involved in the acquisitions that have proven to be value decreasing in retrospect. In this way it is possible think that decisions that were made by over confident managers in the past may also lead to value decreasing decisions later.

If talented executives encounter non-informed investors, executives should provide a value-oriented management approach to such investors. For example, an annual report can not only be used as a report for the last fiscal year, but it can also be a tool for enlightening investors about good and value-creating business principles. Thus, shareholders will not be seen as non-face figures of a constantly changing crowd. They will be considered for the long term. In such a situation, investors can reward management for introducing them with value-creating business principles. When investors become more knowledgeable and conscious by learning value-oriented company management, they can better manage and participate in corporate decisions and better evaluate their decisions.

Sometimes, investors do not know what the best for them so that they can provide wrong interest aligning mechanisms or executive compensation schemes for managers. If this is the case, then managers will make inappropriate decisions for the well-being of investors. On the other hand, as direct control by many small investors is not possible, controlling of the managers by boards may not be useful to increase the value of the company in the long run. For this reason, there are many companies that do not list their shares on the stock exchanges. Because these companies do not want to be dependent on irrational investors who are focused on the short term.

M. Gürünlü 10/3 (2018) 80-94

Managers should limit themselves to a value-oriented management approach. A value-oriented management approach makes earnings management activities manipulating the profit unnecessary. There is a need for conscious investors who think that incentives can be given to managers when there are transactions that really increase value, not when earnings manipulation is done or when companies are shown more valuable than they really are. It is sometimes useful to encourage managers to be shareholders at the same time and not allow them to sell their own shares for a period of time.

With regard to the new shareholders, such questions can be asked: Do managers increase firm value for existing shareholders by selling shares at an overvalued price to new shareholders? Managers can justify this step with their obligations to incumbent shareholders. When the capital base will be expanded by going to public decision, the managers have no obligation for the new shareholders. However, it is possible for new shareholders to retrospectively determine that they will not rely on the management in the future, which has the advantage of being more knowledgeable to them and has sold them overvalued shares.

Research through examining the financial and investment decisions by the behavioral finance perspective shows that managers and investors act irrationally. The proposals in this article are intended to help investors and managers to improve their decisions. This approach, which explains not only the investors' but also the management's decisions with human behaviors is a newer area in finance discipline and the behavioral models have not yet included non-rational managerial behaviors. A two-dimensional behavioral model that takes into account not only the investor but also the managerial preferences will be a breakthrough in finance literature.