

Use of financial-behavior paradigm in company's financial decision making

Zahra Moeinfar¹, Zahra Mousavi², Nasrolla Amoozesh³, Jafar Nekounam⁴

^{*1}Department of Accounting, Daylam Branch, Islamic Azad University, Daylam, Iran

²Department of Accounting, Andimeshk Branch, Islamic Azad University, Andimeshk, Iran

³Department of Accounting, Gachsaran Branch, Islamic Azad University, Gachsaran, Iran

⁴Department of Accounting, khomein Branch, Islamic Azad University, khomein, Iran

Email: zmoeinfar@yhoo.com, Tell: +98-09102911161

Abstract: Financial behavior is an approach which concentrates on the explanation of knowledge by the financers for making decisions on financing. Financial behavior helps in understanding the financial markets and its participants through a new behavioral science (psychology and sociology). Presently, financial behavioral theories help in different ways such as assets pricing; and portfolio choosing and decision making processes that are very important. And financial discovery behavior decision also presents a real psychological explanation. Financial behavior has been applied for analysis of company's financial decision making. Therefore in the present article financial behavior has been studied. Therefore, first we presented financial definition behavior and its models, then the relation between financial behavior and financing decision making in different areas such as virtual choice, technical analysis, foreign financing and financial budgeting have been shown. In the final chapter we present results and summary of content.

[Moeinfar Z, Mousavi Z, Amoozesh N, Nekounam J. **Use of financial-behavior paradigm in company's financial decision making.** *Life Sci J* 2013;10(3s):360-364] (ISSN:1097-8135). <http://www.lifesciencesite.com>. 52

Keywords: financial behavior, behavioral bias, foreign financing, technical analysis.

Introduction

Financial behavior has been introduced as a new field in the financial domain during 90s. In fact though financial behavior started around 150 years ago, this paradigm has been the main interest of psychologists in studying and expansion of economic science. Financial behavior is a psychological application in the financial field. Even though this definition is very short but it explains the financial behavior. Since one of the most important elements in decision making is financing and decision maker's feelings, therefore the paradigm of financial behavior is due to the analysis of feelings effect on financial decisions (kailer & Akar-2009). Financial behavior helps in the market by presenting a new view of behavior sciences (psychology and sociology) for improvement in the financial market and participation in the market (Limberst2008). This approach can be divided into two financial behaviors which are called macro and micro financial behaviors. Micro behaviors of financers and decision making process have been analyzed while macro financial behavior recognizes the un-natural elements available in the markets while behavioral models can determine these elements (Pompain 2006). Financial behavior can be useful in the following cases.

Documentation of share price patterns which seems to be opposite to traditional financial models in the efficient market and rational financing. Those groups of financial behaviors which do not conform to traditional financial theory.

Presentation of recent theories for previously mentioned patterns and behaviors in psychology literature or what can be experienced (Jerjence 2004).

Many researches using many different models of financial behavior in the financial markets have been conducted. Table below shows many models of financial behavior and their findings which have been analyzed by the researchers.

Financial behavior models:

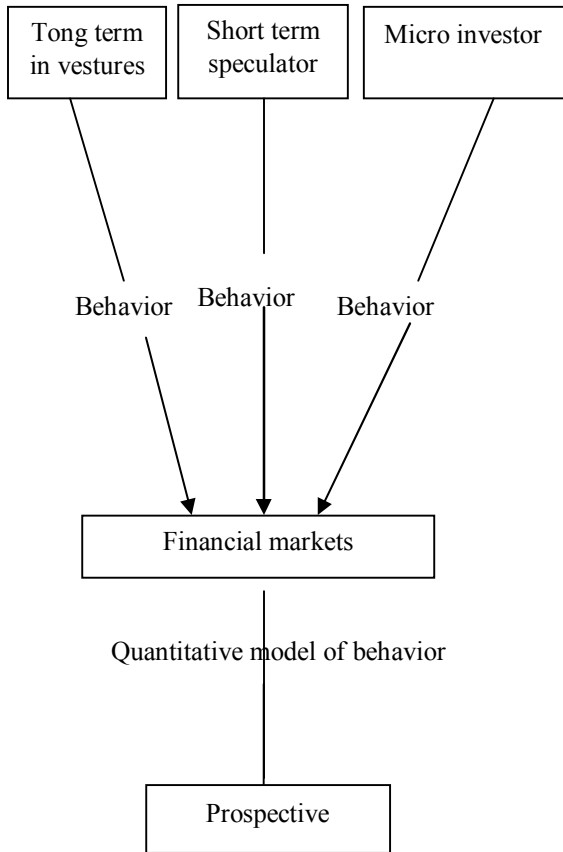
Financial behavior follows the same traditional financial modeling and their real market errors such as transaction expenses, taxes or information asymmetry have been combined (Glaser and Weber)

In traditional financial research a model was suggested initially and then the value of this model was evaluated with the use of practical methods, but in financial behavior approach, first the behavioral patterns prevailing in the financial markets was analyzed and then according to the results obtained from this observation, a model was presented which helps in explanation of behavioral patterns. This model helps in understanding that how does different people in different conditions act. (Silen & Karkemz 2006). Behavioral model act in determination of share price differences (due to extra self confidence for financers), moment strategies, company's size effect and ratio of market value to bookkeeping value share in ratio to more successful traditional financial models.

In recent years using of mathematical and statistical sciences has been prevailing in financial

behavior. In the other words, financial behavior is a new approach of statistical and mathematical methods for understanding behavioral bias, application of mathematics and statistics in financial behavior can be shown as in the following

Diagram:



Total mathematical models behave aural with the way of concern algorithms

Financial behavior and financier’s decision making:

Financial behavior of financiers was effected directly, therefore it is a fixed part in the decision making process. Whenever financiers can recognize behavioral bias and perceptual errors regarding the decision making process, they will be able to act better in decision makings. Understanding of such matters help financiers to plan an optimizing financing strategy and obtain the aim of financing. Also the available differences in data processing by the small and big financiers cause the differences in their transaction behavior. Big financiers are in better condition for new project before it reaches profitability. They recognize the long term fluctuations from short term. But small financiers have little information of the company and therefore for company’s evaluation they have to know the profitability of the company (Ebhijits 2008), and

therefore behavioral bias of big financiers can affect the small financier’s decision making.

Table 1: Financial behavior models

Researcher’s Name	year	models	findings and model forecasting
Barbariz, hang	2001	mental accounting , preferential theory	Finance spending, growth effects, value, fluctuations
Barbariz, hang Santos	2001	Preference theories, money unit effects	Time overhead forecast of share feedback
Jervis & oden	2001	Excess self confidence	High quantity of transaction after success in the financing
Hershifer & loo	2001	Excess self confidence	Analysis of self confidence of financiers in the share competition market

Financial behavior and financial decision making:

According to Cohenman, at present there are many different basis for financial behavior such as assets pricing, portfolio selection, and decision making process which are important (Cohenman 2003). The financial behavior discovery can reveal explanation of real psychological phenomena. Financial behavior is applicable for analysis of company’s financial decision making. Expansion of financial behavior idea for companies’ financial security has been divided into two routes. First route believe that financiers do not act very logical. Company financial security decision makings which are adopted by the company’s management have been analyzed.

This means that logical managers decide according to financing behavior. According to second route it is possible that companies’ managers become behavioral biases. Some of the companies’ financing security is because of those biases. For example managers are usually sure of their work, because they believe in their ability and the company’s improvement (Biren and Broker 2008). Financial behavior can be useful in the following fields and discussions.

Financial behavior and portfolio selections:

Simple meaning of the term portfolio is financing basket or share basket, which means composition of financing assets by a financier. This basket is a complete real and financial asset of financier.

In general, portfolio managers, use financial behavior principals for determining financing strategies. They have reached the result that if there is recognition of non efficiency and it has been analyzed accurately, then there is a chance of obtaining excess

return because may be financiers have irrational behavior in different conditions which this behavior reflect in the market prices (source: alsaqndra). Shegrin in 2005 showed that portfolio selected by the financiers according to preference theory through the key features is different from portfolio selected by the financiers according to utility theory expected. General property of behavioral portfolio is that they are consisted of security stock which some of them are with high risk and some low risk. In the process of portfolio constitution, active financier managers, buy and sell their stock according to their expectation of the future, especially according to future profitability and risk. Final aim of this process is to maximize Alfa which is defined as the differences between adjusted returns on the portfolio risk basis and return for one suitable portfolio. In this sense that ability to maximize Alfa from the capacity for better shaping of expectation has been obtained. In general two potential sources are available for maximizing Alfa:

1. Possibility of access to the private information: active financiers try to create a better information collection which this causes increase in the knowledge regarding the company or the industry which company is active in it.
2. Better processing of information: general assumption is that most information generally are excess able for all financiers who maybe the pulse of the market. This cause ability for better method expansions for this information. This group of portfolio managers is called quantitative managers.

Financial behavior can be introduced as third potential source for increase in the amount of Alfa:

3. Behavioral biases: Managers who consider this third source as the increasing source for Alfa which in some cases the financiers do not try to maximize their assets and in some cases financiers commit some systematic mental error. These two cases are due to behavioral biases. These behavioral biases maybe cause unstable pricing of stock exchange. So far different researchers have analyzed unnatural cases in the market which have been analyzed by the financial behavior theory (George & Vang, Grandy & Martin 2001) (Feranch 1980, & Taylor 1987). Those who have extensive understanding of the effects of these cases on the shares will have excess to unnatural efficiency.

Financial behavior and the policy of dividing profit:

Policy of profit division is one of the most important discussions which are prevailing in the financial management since the dividing profit shows the payments of company's main cash and one of the

most important selections and decisions for the managers. Even though the payment of dividing profit are the direct benefit of the share holders but the ability of the company in keeping the profits for utilization of growth opportunities are affected (Baker & powel 2005).

In addition, this policy in the stock market contains information and changing it also will have some information for the shareholders. Every financier buys the company's stock according to his/her taste which counts the profit division policy suitable (Jehankhani & Parsaian 1384 according to Setayesh & Kazem Nejad).

Financial behavior can affect the policy of profit division policy. Studies show that young financiers buy the share of the companies which have low profitability division while the older financiers finance in the share of the companies with higher profitability division among the share holders (leaze 1976)

Financial behavior and capital budgeting:

Capital budgeting is a process which companies use for determination of resources financing. Capital budgeting process defines the total and size of real assets which cause horizontal movement and therefore determination of profitability and value of the company. According to this process some decisions such as investment in the new plans, allocation of resources, and study of other companies and renewal of evaluation of the amount invested in the present plans are pursued. In general, company's decision on adoption or rejection of financing in the new projects has been pursued in this base that this plan causes increase in the wealth of financiers of the company or not. As an example, law of net current value (NPV) determines an objective process, cash receipts and payments should be according to a determined rate, while present value of cash receipt is because of project in which payment is more and this project has been chosen and executed by the company. Since future cash flows of a project and its value reduction should be evaluated therefore this process is relatively subjective and therefore behavioral trait of managers can affect this project.

Research conducted in this regard by different researchers in financial behavior show that the companies' managers like the financiers may become self- confidence in decision making, which this cause behavioral biases and imprecise decision making, it means that they may have excess self-confidence on their ability and activities and they may invest the company's cash very fast and without careful thinking which results are not so good for the company. Since it is possible that this behavior of the managers cause excess financing not to have much profits (Simin2009).

Financial behavior and technical analysis:

Technical analysis is a method for evaluation of stock exchange with statistical analysis of market activities such as past prices and capacity of stock transactions. Technical analysis analyzes the historical data and tries to follow special laws for stock exchange dealing with the aim of maximizing the profit and minimizing risk of losses. In this analysis different diagrams and indexes have been used to recognize samples which can be considered as the guide for future activities. This analysis tries to understand the feelings in the market by studying the market itself. Technical analysis consists of vast area of forecasted

techniques such as analytic diagram, analysis and recognition of patterns and computer systems.

Financial behavior has acted correctly and successfully in this kind of behavior that which portfolio selection should be kept and which one should be sold. In both financial behavior models such as technical analysis and psychological – feelings elements technique this have been noticed. In behavioral models, when the prices of stocks increase, the traders buy the stocks and when it decreases they sell them which is the same as technical analysis (Vasillo and colleagues 2008).

Table 2: **Financial behavior and financial puzzles**

No.	Financial puzzle	solution
1	Over and under reaction	Conservatism, agents innovative method
2	Excessive trading and gender puzzle	Excess confidence
3	Hypes and panic	Theory of cognitive abnormalities
4	Equity premium puzzle	Mental accounting & loss aversion
5	Winner/loser puzzle	Mental accounting & loss aversion
6	Dividend puzzle	Mental accounting & loss aversion& self-control

Financial behavior and financial puzzles:

Financial behavior can help in solving some of the financial puzzles through preferred theory elements. These puzzles and their solution according to financial behavior are presented in the following

Financial behavior and pricing of capital assets:

Shefrin and Estatman 1994 overviewed pricing model of capital assets and according to that a new theory with the name of model in behavioral pricing of assets (BAPM)(behavioral asset pricing method) have been presented. According to the theory there are two groups of traders who are active in the market. First group are those who are having perceptive error in their decision making and they are called information trader, but the second group are those who are having perceptive error (noise trader), expected return of stock exchange in this model are determined with Behavioral Betas. These Betas are not regarding the efficiency of market portfolio since the second groups are traders in the market, who influence the stocks exchange market. For example traders' preference for growth of stock may be the price of stock and as a result share (stock) values will be increased. Here we should mention that there are some problems together with Beta estimation because composition of portfolio will change with time and it won't remain constant (Estitman 1999).

Financial behavior and foreign investment:

Studies show that financial behavior can affect the processes of decision making regarding foreign investments. Classification of behavioral laws in decisions regarding direct foreign investment can be shown in the following table:

Table 3: **Financial behavior and financial puzzles**

time	National	Foreign
past	Training, effect of internal money units, mental accounting, lost expenses, perceptive bias, effect of equal point.	Historical anchoring
present	present ability, capable of forming	Availability, fairness, messaging, general wrong biases
future	Excess Self -confidence, adaptive biases	

Resulting:

Financial behavior in 90th decades is counted as a new field of finance, even though establishment of financial behavior basis can be more than 150 years old. This approach analyzes the psychological and social elements which affect people's financial decision

making, and different institutes and groups. In the other words financial behavior tries to show what you are, why you are and the method of investment processes and financial provision through the human view, to show that financial behavior and its different method of recognition can affect the decisions of people and

companies. Recognition of this field and analysis of reasons for occurrence in the financial market cause excess recognition of market capital and the models of decision making of people. For example when the investors can recognize the behavioral biases and perceptive error is connected to decision making process. They will be able to act better in their decision making, understanding of such elements help the investors to plan an optimized strategy for investment and reach their investment aim.

Financial behavior and technical analysis:

Technical analysis is a method for evaluation of stock with the use of statistical analysis of market activities such as previous prices and capacity of transactions of stocks. Technical analysis analyzes the historical data and tries to determine special laws for buying and selling (dealing) with stock exchange with the aim of maximizing the profits and minimizing the risk of loss. Different diagrams and indexes are used to recognize the samples which can be counted as the guides for future activities. This analysis tries to understand the market's feelings according to studies conducted from the market itself. Technical analysis consists of vast areas of technical forecasting such as analytic diagrams, analysis and recognition of patterns, cycle analysis and computer systems.

Corresponding Author:

Zahra Moeinfar

Department of Accounting, Daylam Branch, Islamic Azad University, Daylam, Iran

Email: zmoeinfar@yhaoo.com

References:

1. A.ceylan, T. Korkmaz, (2006). Sermaye Piyasas: Ve Menkul Deger. analiz. Ekin Kitapevi, Bursa, pp. 609 – 610
2. Abhijeeet, Chandra. (2008). decision making in the stock market: incorporating psychology with finance. national conference October T 2008 T kharagpur, paper no. 21288.
3. Alistair Byrne, Mike Brooks (2008). Behavioral Finance: Theories and Evidence. The Research Foundation of CFA Institute literature Review.
4. Gervais, S., Odean, T. (1997): Learning To Be Overconfident, The review of financial studies, Spring 2001, Vol 14. No. 1, pp 1-27, Available at SSRN: <http://ssrn.com/abstract=36313> or doi:10.2139/ssrn.36313 (accessed 22 November 2010)
5. Hirshleifer, D. (2001): Investor Psychology and Asset Pricing, MPRA paper, No 5300, Available at <http://mpa.ub.uni-muenchen.de/5300/> (accessed 14 November 2010)
6. Innocent, alessandro., santoni, alessandro. (2010). applying behavioural finance to investing.
7. Kahneman, D. (2003). A Psychological Perspective on Economics, The American Economic Review. Vol. 93O. 2.
8. Kiyilar, murat., Acra, Okan. (2009). Behavioral Finance and The study of the irrational financial choices of credit card users. Annales universitatis Apulensis series oeconomica, 11 (1). pp.457 – 468.
9. Lamberts, s. w. j. (2008). new insights into behavioral finance ISBN. 978 90 5170 9209
10. M. pompain, (2006). Behavioral Finance and Wealth Management: How to Build optional Portfolios that Account for investors biases, John wiley and sons, ABD, p.3.
11. Prast, henriette. (2004). investor psychology: a behavioral explanation of six finance puzzles. research series superrision, no. 64.
12. Ramesh, Thimmaraya. Venkateshwarlu, masuna. (2011). A new Quantitative Behavirol Model for Financial Prediction. 3rd international conference on information and financisl Engineering. IACSIT press, singapore
13. Ricciardi, Victor, Simon, Helen K (2000). What is Behavioral Finance ? Business, Education and Technology Journal.
14. Shokey, S.S., and S. B., seiling. (2004). Moving into Action: Application of the transtherical Model of Behavior change to financial Education. Financial counseling and planning, 15 (1), pp. 41 – 52.

1/15/2013