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THE ROLE OF CULTURE IN SHAPING MANAGERIAL OVERCONFIDENCE AND ITS IMPACT ON FINANCING DECISIONS

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Abstrak: Model ekonomi tradisional yang mengasumsikan pengambilan keputusan rasional tidak dapat menggambarkan secara akurat kompleksitas dalam pengambilan keputusan keuangan. *Behavioral Decision Theory* dapat menjelaskan kesenjangan antara teori struktur modal klasik dan bukti empiris yang tidak konsisten. *Behavioral Decision Theory* menghubungkan nilai-nilai budaya, *overconfidence* dan pengambilan keputusan keuangan, dengan dilandasi asumsi rasionalitas terbatas. Studi ini mensintesis sejumlah penelitian terdahulu tentang keputusan pendanaan dari perspektif keperilakuan untuk memperluas literatur yang sudah ada. Budaya merupakan aspek penting dalam organisasi yang perlu mendapat sorotan khusus. Budaya memainkan peran penting dalam membentuk bias perilaku. *Overconfidence* merupakan salah satu bias kognitif sering dikaitkan dengan pengambilan keputusan keuangan dan biasanya melekat pada diri manajer. Perbedaan budaya dan *managerial overconfidence* berdampak pada keputusan pendanaan.
Kata kunci : *behavioral decision theory*; budaya; keputusan pendanaan; *managerial overconfidence*

***Abstract**: Traditional economic models that assume rational decision-making may not accurately capture the complexities of real-world financial decision-making. Behavioral Decision Theory can explain the gap between classical capital structure theories and inconsistent empirical evidence. Under the assumption of bounded rationality, Behavioral Decision Theory linking cultural values, overconfidence and financial decision making. Culture is an important aspect in organization which need close attention. This study synthesises earlier studies about financing decisions from the behavioral perspective to broaden the scope of existing knowledge. Culture play a*

vital role in shaping behavioral biases. Overconfidence is one of the well-known cognitive biases in financial decision making that often seen in managers. Cultural differences and managerial overconfidence have impact on financing decisions.
Keywords: *behavioral decision theory*; *culture*; *financing decisions*; *managerial overconfidence*

INTRODUCTION

Financing is one of the basic financial decisions concerning the firm's capital structure. In the neoclassical financial paradigm, managers are considered rational in making financial decisions such as capital structure. Managers are assumed to have complete knowledge and ability to update their information, and imperfections are ignored. However, recent empirical has revealed that behavioral factor such as managerial overconfidence can affect firms' financing decisions (Hackbarth 2008; Heaton 2002; Ishikawa & Takahashi 2010; Malmendier et al. 2023, 2007, 2011; Malmendier & Tate 2015; Mundi & Kaur 2022). A behavioral approach in financing decisions is beneficial in the corporate decision-making process. The addition of behavioral biases helps to explain classic financial riddles.

Behavioral decision theory combines psychology, cognitive science, and economic insights to understand how individuals make decisions. Unlike traditional economic theories that assume individuals are perfectly rational and always make decisions to maximize utility, Behavioral Decision Theory acknowledges that various cognitive biases, heuristics, emotions, and social factors influence human decision-making. Becker and McClintock developed Behavioral Decision Theory based on Value Theory, Behavioral Theory and Game Theory. Becker and McClintock argue that the actions and choices of individuals are influenced mainly by the principles and beliefs they uphold (Takemura 2014).

Behavioral Decision Theory discusses two interrelated aspects, that are normative and descriptive. To some degree, normative and descriptive models reflect the nature of actual human decision-making. Normative models generally express decision-making with a mathematical approach. Meanwhile, descriptive models describe how individuals actually act in the decision-making process by considering their beliefs and values. The descriptive aspects emphasize the psychological aspects of individual consideration and decision-making, which involve judgment, inference and choice. However, even descriptive theories seek a certain level of rationality in human decision-making (Takemura 2014).

The underlying assumption of Behavioral Decision Theory is bounded rationality (Takemura 2014). The bounded rationality perspective reveals that managers' decision-making processes are limited by biases, values, skills, and habits (Esghaier 2017). Human brain often processes information briefly due to the influence of psychological aspects. For example, someone often makes decisions based on their experience without going through training. This decision-making process is related to rational boundaries, which cause individuals to appear irrational. The cognitive constraints of individuals, together with their limited knowledge, might lead to the emergence of behavioral bias. The overconfidence bias has been empirically supported in the field of behavioral finance related to financial decision-making (Baker & Nofsinger 2010). Overconfidence is one of the characteristics inherent in managers (Reyes et al. 2022). People tend to be excessively confident in proposing judgments and overestimate their abilities in tasks that require specific skills.

Human behavior is primarily governed by the values they uphold. Values are the essence of culture (Hofstede et al. 2010, p. 6) that guides the behaviours of managers

(Chandrasena 2019). Culture affect individuals' beliefs about their abilities, that contribute to the level of confidence (Culpepper & Romero 2017; Meisel et al. 2016). The relationship between culture and overconfidence is complex, and the findings have been inconsistent. A study indicates that managers in countries that emphasize on individualism exhibit greater belief in their own capabilities and are tend to be more overconfident than managers in countries that emphasize on collectivism (Antonczyk & Salzmann 2014). In contrast, other studies show that individuals from collectivistic countries display higher level of overconfidence compared than individuals from individualistic countries (Czerwonka 2017; Meisel et al. 2016; Statman 2008).

Culture is an essential aspect to pay attention to in organizations because cultural values affect the personal characteristics of entrepreneurs or managers who in charge in making financial decision. Several researchers study the relationship of culture and financing decisions (Antonczyk & Salzmann 2014; Esghaier 2017; Farooq et al. 2020; Lam et al. 2013; Mogha & Williams 2021). Different cultural values can lead to different choices of capital structure.

This study is designed using a narrative literature review approach. Most of empirical studies about financing or capital structure decision are based on neoclassical financial paradigm. Meanwhile, this study synthesises earlier studies about financing decisions from the behavioral perspective to broaden the scope of existing knowledge. Different cultural background can lead to different level of overconfidence in the context of financial decision-making. Understanding the influence of culture on overconfidence is important for decision-making, and organizational behavior. Therefore, exploring cultural values and analysing their impact on managerial overconfidence and financing decisions sheds light on the various choices in financing decisions.

METHOD

A literature review offers an extensive review of existing literature regarding a specific issue, theory, or approach. This narrative literature review was conducted through 4 steps protocol (Demiris et al. 2019). The first step is planning the process and choosing the database to capture relevant research articles. The search was conducted using the Scopus database and Google Scholar. The topic is chosen in this step.

The second step of the literature review is to identify the keywords and exclude duplicate articles. The search strings used were "culture" and "overconfidence", "culture" and "capital structure", "culture" and "financing decision", "overconfidence" and "financing decision", "overconfidence" and "capital structure", "behavioral finance", and "behavioral theory".

The third step includes reviewing the abstracts and articles. Before reviewing the abstracts, articles were chosen based on the title. This review focuses on culture, national culture, managerial overconfidence, and financing decisions (capital structure), and its relationship. The last step is done by summarising and synthesising the findings and integrating them into the writing.

DISCUSSION

THE ROLE OF CULTURE ON MANAGERIAL OVERCONFIDENCE

Culture is a communal phenomenon, as it is partially shared among those who live in the same social environment (Hofstede et al. 2010, p. 6). Values serve as the persistent component of culture (Hofstede et al. 2010, p. 28). Hofstede's cultural dimensions are often used in cross-cultural studies related to managerial overconfidence. Cultural dimension refers to a specific characteristic of a culture that may be quantitatively compared to other society cultures. The cultural dimension that frequently used in study behavioral biases is individualism and collectivism.

Cultural values, such as individualism and collectivism, can shape overconfidence levels. Antonczyk and Salzmann (2014) used individualism and collectivism parameters taken from Hofstede's cultural dimensions to measure overconfidence and optimism. Antonczyk and Salzmann (2014) assumed that managers in individualistic countries are to be overconfident, so they used individualism as a parameter of overconfidence.

In contrast to previous research, Statman (2008),Meisel et al. (2016) and Czerwonka (2017) show that individuals from collectivistic countries are more overconfident and tend to take more risk than individuals from individualistic countries. Individuals with strong individualist values tend to make decisions independently rather than as part of a group. This type of person tends to feel more vulnerable in high-risk circumstances since they have less support from other cultural group members and then make less risky decisions. On the other hand, individuals with collectivist values tend to be overconfident due to the safeguarding provided by their close-knit social circles (Culpepper & Romero 2017; Statman 2008).

Moore et al. (2018) utilize various methods, including quantitative analysis, experimental studies, case studies, and comparative analysis, to explore the influence of culture on overconfidence. The participants are from the United Kingdom (UK), United States (US), India and Hongkong. UK and US are considered individualistic countries, whereas India and Hongkong are considered collectivistic countries. Overconfidence is measured by three dimensions: overestimation, overplacement or overprecision. The findings show that participants from Hong Kong and India showed less underprecision (better calibration) compared to participants from the UK and the US, indicating potential cultural differences in precision. The result also indicates higher overestimation in Indian participants. Even though collectivism may contribute to overestimation, it may not have a significant impact on other forms of overconfidence such as overplacement or overprecision. It is possible that collectivism, which emphasizes group harmony and conformity, may contribute to overconfidence by fostering a sense of collective self-esteem and a tendency to overestimate one's abilities within the group.

Culpepper and Romero (2017) discuss overconfidence in decision-making associated with Chinese culture. The overconfidence phenomenon among Chinese people can be known from their history and traditional cultural values. Historical social values in China, which derive from Confucian values, influence decision-making. Confucius created a moral guide for government and society, promoting hierarchy, group orientation, and respect for traditions and elders. These values are still considered important in modern Chinese society and remain a major cultural force underlying leadership practices in China. Most Chinese CEOs manifest Confucian ideology in their leadership practices. The business strategies implemented by company leaders who hold Confucian values do not appear aggressive, even though these leaders are generally hardworking and ambitious figures. In this view, cultural values are related to the overconfident nature of Chinese people.

Cieślik et al. (2018) investigated the relationship between national culture and overconfidence in entrepreneurs from 23 European Union (EU) countries. Culture are measured by Hofstede’s cultural dimensions. The results indicate that societies with higher long-term orientation, are less overconfident. A positive relationship exists between uncertainty avoidance and overconfidence. Societies that value masculinity, which emphasizes achievement and competitiveness, are tend to be more overconfident. Culture and experiences can impact individuals' cognitive biases and heuristics, as well as their risk perception and tolerance (Statman 2008; Yates 2010; Yates & de Oliveira 2016). Cultural values shape the mindset and behavior of individuals within a society, including managers. Social environment, trust levels, and social networks can affect managers’ willingness to engage with financial transaction and influencing their confidence in making financing decisions.

THE ROLE OF CULTURE ON FINANCING DECISIONS

Financing decisions relate to the capital structure of the firm. Conventional capital structure theories, such as the trade-off theory and pecking order theory, originated with the assumption that individuals act rationally. Therefore, the literature mainly concentrates on weighing the advantages and disadvantages of utilizing debt vs equity. Recently, studies have shown that cultural factors might influence judgments regarding capital structure decisions(Farooq et al. 2020; Lam et al. 2013; Mogha & Williams 2021).

Lam *et al.* (2013) proposed the Norm Theory of Capital Structure, which explains the influence of managerial norms on capital structure decisions, in addition to other conventional factors. Managerial norms consist of manager-subordinate and manager-environment relationships. Lam *et al.* (2013) relied on Hofstede's national culture to predict social norms. The manager-subordinate norm specifies how managers should interact with their subordinates within the organization. Hofstede's two cultural dimensions, power distance and individualism versus collectivism, are used to capture the manager-subordinate norm. The manager-environmental norm explains how managers engage with the environment outside of the company. Masculinity vs femininity and uncertainty avoidance are likely to reflect the manager-environment norm. Lam *et al.* (2013) tested hypotheses using panel data consisting of 16,304 firms from 30 countries. The results indicate that a strong hierarchical relationship between managers and subordinates and an adaptable interaction between managers and their environment are associated with lower debt levels in multiple countries. A strong hierarchical relationship between managers and subordinates is characterized by high power distance and high collectivism. An adaptable interaction between managers and their environment is characterized by high masculinity and high uncertainty acceptance. Managerial norms are more significantly related to leverage ratios in small firms than in large firms, meaning that managers/owners of small businesses are more influenced by norms in making financing decisions compared to managers in large firms (Lam et al. 2013).

Antonczyk and Salzmann (2014) used individualism and collectivism parameters taken from Hofstede's cultural dimensions to measure overconfidence and optimism. Antonczyk and Salzmann (2014) examine the relationship between individualism – collectivism, and capital structure. The results indicate that firms' external financing choices are significantly influenced by behavioral biases (optimism and overconfidence) that rooted in cultural differences, and countries with higher individualism scores have higher debt ratios.

Several studies confirm the influence of culture on financing decisions. Farooq et al. (2020) showed that financing decisions are influenced by national culture. However, the specific cultural elements within it exert different levels of effect. Long-term orientation positively impacts the debt-to-asset ratio while negatively impacting the long-term debt-to-asset ratio. Additionally, masculinity exerts a favourable influence on the overall debt ratio while exerting an unfavourable influence on the long-term debt ratio. The findings of Mogha and Williams (2021) indicated that Hofstede's cultural dimensions affect capital structure. However, the influence has a more significant impact on short-term debt ratios than long-term debt ratios, although it does affect both.

Chandrasena (2019) explores the role of culture among CEOs in financing decisions. The study goes beyond CEO's nationality to examine the influence of their cultural values on firm leverage decisions. The findings show that the cultural values of mastery and embeddedness have a notable and favourable influence on the increase in firms' debt. Chandrasena (2019) suggests that cultural values inherited from nationality affect financial decisions.

Cultural values affect individual’s perception, expectation, and cognitive processes in decision-making (Yates & de Oliveira 2016). Cultural background can impact financial decision-making, as cultural values shape individuals' attitudes and behaviors towards money and financial choices (Yates & de Oliveira 2016; Zhou et al. 2022). Cultural norms and beliefs about money, wealth, and material possessions can impact individuals' financial goals and priorities. Culture can influence financing decisions through individuals' risk preferences. Managers consider the perceived benefits and costs of having debt, as well as the choices of other variables in the financing decision-making.

THE EFFECT OF MANAGERIAL OVERCONFIDENCE ON FINANCING DECISIONS

Managerial overconfidence refers to the tendency of managers to have an inflated belief in their own abilities and the accuracy of their judgments (Baker & Ricciardi 2014). Overconfident managers tend to exhibit above average effect and increase in control perception (Invernizzi 2018, pp. 7–8). Managers who are excessively confident think that the work they initiate is more visible than it is in fact. When a manager is confronted with a challenging situation, the level of overconfidence displayed is related to his belief that he performs above average, even though he might not.

There are three dimensions of overconfidence, which include overestimation, overplacement and overprecision. Overestimation refers to overestimating actual performance, overplacement refers to exaggerating one's performance relative to others, and overprecision refers to excessive belief in one's known truth (Moore & Schatz 2017). Overconfident managers tend to underestimate cash flow volatility and overestimate the company's ability to generate profits (Malmendier et al. 2007), thus leading to suboptimal financing decisions.

Managerial overconfidence can be measured using various methods, including self-assessment surveys and objective performance measures (Cieślik et al. 2018). Self-assessment surveys involve managers rating their own confidence levels and making predictions about future outcomes (Jude & Adamou 2018). These surveys can capture subjective perceptions of overconfidence, and the survey can be derived from other trusted parties (Esghaier 2017). Objective performance measures involve comparing managers' predictions or decisions with actual outcomes. Objective measures can be done by analysing financial performance, stock market returns, stock option, project success rates, or analysing managers' risk-taking behavior, such as the frequency and magnitude of risky investments or decisions (Hackbarth 2008; Ishikawa & Takahashi 2010; Malmendier et al. 2007, 2011, 2023; Malmendier & Tate 2015; Mundi & Kaur 2019; Park & Kim 2009; Ting et al. 2016). Studies that investigate managerial overconfidence in corporations or large firms often use objective performance measures. Recent studies, measure managerial overconfidence by textual analysis of annual reports, news and articles that could expose CEO overconfidence (Mundi & Kaur 2022; Park et al. 2020). Nevertheless, combining multiple measures can provide a more comprehensive understanding of managerial overconfidence and its impact on decision-making.

The relationship between managerial overconfidence and financing decisions was proposed by Malmendier *et al.* (2007). Their findings show that overconfident managers consider external financing too expensive, especially equity financing, so they prefer debt over equity when external financing is raised. Overconfident managers believe that the market price for riskless debt financing is accurate, whereas the market price of the company's equity is viewed as too low. This finding is supported by Oliver and Mefteh (2010), Mundi and Kaur (2022), Malmendier et al. (2011) and Malmendier et al. (2023). Additionally, Malmendier et al. (2011) found that overconfident managers tend to use internal funds rather than seeking external funding from capital markets, and they choose to utilise debt if they have to raise capital. On the contrary, Ishikawa dan

Takahashi (2010) found that managers with overconfidence bias tend to choose equity financing.

A study conducted by Hackbarth (2008) revealed that overconfident managers underestimate the risk of income, which leads to risk perception bias. Overconfident managers believe that their firm has a lower risk than it genuinely does, leading to a lower chance of encountering financial difficulties. Therefore, managers with overconfident bias tend to choose high levels of debt. A positive relationship between overconfidence and leverage is also shown by Park and Kim (2009) and Esghaier (2017). Jude and Adamou (2018) investigated the influence of overconfidence among managers / small and medium-sized enterprise (SME) owners. The findings indicate that overconfidence positively influences the probability of managers / SME owners to utilise bank loans as a source of financing. This fact contradicts the pecking order theory, which argues that managers prefer internal funding over loans.

Managerial overconfidence plays a significant role in the financing decisions made by organizations. Overconfident managers may be more inclined to pursue ambitious and risky projects, leading to increased borrowing and higher leverage ratios. Overconfidence can have both positive and negative implications for the organization. Overconfident managers tend to ignore competition, underestimate risks and implement less control functions due to overestimating their abilities(Gudmundsson & Lechner 2013). Overconfident managers may underestimate the risks of a particular investment or overestimate the potential returns. Overconfident managers tend to pursue risky projects that do not align with the firm's financial capabilities. As a result, the organization will bear excessive debt. On the other side, overconfidence can drive managers to take on innovative and growth-oriented projects that have the potential for high returns. Therefore, understanding managerial overconfidence is crucial for organizations to make optimal financing decisions.

IMPLICATIONS FOR MANAGERS AND ORGANIZATIONS

Understanding the influence of cultural and behavioral factors on financing decisions is important for managers and organizations. Managers need to be aware of their biases and overconfidence tendencies to improve decision-making processes. By acknowledging the role of culture on managerial overconfidence and its influence on capital structure, the firm can make optimal financing decisions and enhance its financial performance.

Organizations can also play a role in reducing the negative impact of managerial overconfidence. Organizations can implement several strategies to improve financing decisions in light of culture. First, organizations should promote diversity and inclusion within their workforce. By having a diverse team with varied cultural backgrounds, organizations can benefit from different perspectives and reduce the influence of any single cultural bias. Second, organizations should encourage the use of data and evidence-based analysis in financing decisions. By relying on objective information rather than subjective beliefs, managers can make more informed choices that align with the organization's financial goals. Third, organizations should invest in training programs that focus on financial literacy and decision-making biases. Managers should be educated about the potential biases associated with managerial overconfidence and the impact of cultural values on decision-making. By equipping managers with the necessary knowledge and skills, organizations can empower them to make more objective and rational financing decisions. Additionally, implementing effective monitoring mechanisms, such as regular performance evaluations and compensation structures aligned with long-term performance, can mitigate the negative effects of overconfidence. Corporate governance practices can be important in managing managerial traits, including overconfidence. Strong corporate governance practices can provide checks and balances, ensuring that decision-making is based on rational analysis rather than overconfidence.

CONCLUSION AND FUTURE RESEARCH DIRECTIONS

Culture are vital in shaping managerial overconfidence and subsequently impact financing decisions. Behavioral Decision Theory is compatible for describing how culture and cultural differences might lead to different levels of overconfidence and variation in financing decisions. Cultural values influence the rise of managerial overconfidence, which subsequently impacts managers' decision-making processes, particularly in financing decisions. Understanding the influence of cultural values and managerial overconfidence on financing decisions is crucial for organizations to make optimal financing decisions and mitigate potential risks. Promoting cultural diversity, fostering evidence-based analysis, increasing financial literacy, and enhancing corporate governance practice can improve the financial decision-making processes, especially capital structure decisions.

Ethnic and cultures create diversity within countries. Therefore, future research should delve deeper into the specific cultural factors that influence overconfidence and financing decisions. Future research should also identify strategies for optimal financing decisions and examine the effectiveness of different strategies in mitigating the negative effects of overconfidence. By expanding our understanding of these dynamics, organizations can unlock the power of culture to make optimal financing decisions that lead to better financial performance.

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