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**BEHAVIOURAL CORPORATE FINANCE AND THE FIRM'S
DIVIDEND POLICY**

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Abstract

This article focuses on behavioural finance issues. The study shows the difference between the theory of behavioural finance and neoclassical financial theory and highlights the main areas of application of the behavioural approach in the field of corporate finance. The existence of a variety of articles and studies on the definition of behavioural finance in recent years suggests that it is a relatively new but rapidly and dynamically developing area of knowledge, focusing on the search for explanations of economic decisions that people make. The concept of behavioural finance combines theories of behavioural and cognitive psychology with generally accepted notions of economics and finance. Based on the analysis of research data, it can be concluded financial behaviour cannot be described using the apparatus of classical financial theories and models with a sufficient degree of reliability. The need for research in the field of behavioural finance lies in the impossibility of explaining many empirical observations within the framework of classical financial theory about rational investors. They operate inefficient markets and seek to maximize utility. In this article, the foundation of the study of behavioural finance is the focus on the behaviour of an individual and groups of people in general. The concept of behavioural finance allows considering the issues of business valuation, M&A transactions, market efficiency and inefficiency, and the problem of investor decision-making since there are examples when investors make decisions that are not justified from the current methods.

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1. Introduction

According to numerous studies that have been carried out in recent decades related to the behaviour of the market in general and the movement of market prices, it can be seen that they cannot be described with a sufficient degree of reliability by classical financial theories and models. The main reason for this phenomenon is that the behaviour in the market of investors cannot be predicted from one type of behaviour and it cannot be calculated by the formula or assumptions that underlie these theories and are considered essential for the possibility of their effective use (Baker & Nofsinger, 2011). People are exposed to a variety of emotions, misperception of information, illusions, and similar other factors when they act under conditions of uncertainty and risk. That is why, over the past decades, based on the existence of such factors and the study of their impact on the process of making investment and financial decisions, new financial science has emerged – "behavioural finance" (Kovalenko, 2011).

The notion of behavioural finance belongs to neoclassical financial theory. The opinion about the rational behaviour of market participants and the deviation in the decision-making system is questioned (Lapteva et al., 2019).

2. Problem Statement

There are several assumptions in behavioural finance:

1. There are both rational and irrational decisions in the behaviour of the subject of economic relations;
2. The form and structure of information significantly influence decision-making;
3. Irrational behaviour affects corporate governance and the pricing of financial resources.

The founder of behavioural finance is Hersh Shifrin.

The theory of behavioural finance precisely explains the influence of psychology on financial activity (Kosorukova, 2013). Particular difficulties were associated with the traditional financial paradigm, and this is partly why this approach arose.

3. Research Questions

The core of the traditional financial paradigm is those representative agents (individuals) are entirely rational.

Two properties explain rationality:

1. Individuals, having received new information, following Bayes' rule, correctly incorporate it into their ideas.
2. The adoption of normatively correct decisions is carried out based on existing ideas, i.e. internally consistent and consistent subjective expected utility theories

4. Purpose of the Study

When people act under conditions of uncertainty and risk, people are exposed to a variety of emotions, misperception of information, illusions, and similar other factors. That is why, over the past decades, based on the existence of such factors and the study of their impact on the process of making investment and financial decisions, new financial science has emerged – "behavioural finance" (Kovalenko, 2011).

So, what is "behavioural finance"? There are many articles and monographs about this definition. We can claim that this is a relatively new but rapidly developing area of knowledge, focusing on finding explanations for economic decisions that people make, and combining theories of behavioural and cognitive psychology with generally accepted concepts of economics and finance (Kovalenko, 2011). The inability to explain many of the empirical observations in classical financial theory about rational investors operating inefficient markets and seeking to maximize utility has all contributed to the growth of behavioural finance research. An attempt is made here to solve this issue, and the behaviour of an individual and groups of people, in general, is taken as a basis. In terms of business valuation, mergers and acquisitions, for example, behavioural finance helps to answer the question of how and why markets can be ineffective or why investors make decisions that are not justified in terms of current methodologies (Fedotova, 2014).

Let us consider a brief history of research in this area of expertise for a deep understanding of behavioural finance concept:

- Le Bon's (1885) "Psychology of peoples and masses". One of the first examples of irrational behaviour by researchers was the so-called "crowd effect". The specific effect that the crowd has on people was first tried to describe by the French sociologist – Gustave Le Bon. He noticed that acting in a group, and people turn into a single whole, which has a collective consciousness. This consciousness makes the members of the group behave according to the behaviour in the group, which usually does not coincide with the behaviour that they would behave, how they would behave when acting alone. Thus, according to Le Bon's research, the actions and feelings of the crowd are "highly contagious," and often force people to be on the side of collective interest, sacrificing their interests.
- McKay's (1841) "Extraordinary Popular Delusions and the Madness of Crowds". He attributed the formation of speculative bubbles in the market to episodic outbreaks of mass hysteria.
- Langer's (1975) "Illusion of control". She argued that a person, by nature, is inclined to take on much greater risk if he participates in a game, the conditions of which are formulated in such a way that the need to perform certain actions gives the player the "illusion of control." That person is confident that the result depends on his abilities. That is, utterly identical, but differently formulated games, people can influence the decision of the player to take or not take part in them, and the amount of money that he is willing to risk in this game. The "illusion of control" can also arise under a different formulation of conditions.
- Allais (1911) - "The behaviour of a reasonable person in conditions of risk, criticism of the postulates and axioms of the American school". According to his research, namely the theory of expected utility, when it is necessary to choose one of the options, a person always chooses

the one in which the expected utility is great, that is, he prefers the option that suits him the most, not being guided by any financial theories;

- Craik's (1943) "The Nature of Explanations", Scottish psychologist. He wrote that each person is, in a way, an information processor, and he builds intelligent models of reality that help him imagine the further development of an event. According to Craik, having in mind a "small-scale model of external reality and possible actions", we can "test various options for behaviour, conclude the best behaviour, react to future situations even before they arise, use knowledge of past events dealing with the events of the present and the future, and responding to the emergencies we face in a much more complete, safe and competent way".

Moreover, it is this ability to anticipate future events that are essential for market decisions in the face of uncertainty and risk.

The human brain is designed in such a way that it often makes people see patterns where they do not exist; that is when several similar events create the belief that this will happen again. This process is because people often lose the ability to correctly analyze and perceive reality and begin to use simplified models of reality. It is a mechanism or normal brain reaction, that cannot handle a large amount of information and in response, turns on natural defences. Moreover, this interferes with making the right decisions, since in this case, some of the necessary information is discarded and utterly unnecessary for making a decision is included (Lapteva & Ogorodnikova, 2018).

Now we can look at the actual impact of behavioural finance on business valuation. Financial phenomena are better explained using models, but not all participants are entirely rational - the behavioural paradigm asserts.

5. Research Methods

There are certain postulates that behavioural theory rejects:

Individuals can make normatively unacceptable decisions do not necessarily assimilate new information following Bayesian rules, while decisions can violate expected utility theory.

There is a theory of rational expectations. Its essence is that individuals have individual rationality, as well as correct ideas. Most financial asset pricing models are based on this theory.

Correct representations are subjective distributions of unknown predicted variables and are objectively correct.

Individuals must have enough data to form correct ideas about the probability distribution of predicted variables, as well as to incorporate new information.

Behavioural finance does not accept the rational expectations theory. A behavioural approach is of particular importance to corporate finance management. Maximizing a firm's shareholder value is a major corporate finance problem.

6. Findings

There are two groups of factors that prevent this:

- internal;

- external.

Behavioural delays (internal obstacles) are those losses that are caused by the mistakes of managers due to limited cognitive resources, as well as under the influence of emotions.

The next group of obstacles comes from the cognitive errors of investors or financial analysts. They can lead to a discrepancy between the fundamental value and the market price of the firm.

Due to possible mistakes of investors and analysts, managers do not always make the right decisions related to the financial management of the company.

Internal barriers include agency costs that arise as a result of the diverging interests of managers, owners, or shareholders of the firm. The problem of agency costs can be solved by a rationally designed system of contracts and remuneration, as well as increase the shareholder value of the company. If the manager misunderstood his interests and the actions that need to be taken, then. As a result, the behavioural costs will be very significant, and it will be impossible to reduce them either by a rational system of contracts or by wages.

If we consider the external obstacles to maximizing the value of the firm, it can be noted that the market price of the company deviates quite significantly from the fundamental value. The managers' actions in such a situation are mainly aimed at increasing the company value and lead to a decrease in its market value. Adjustments must be made to traditional management methods to account for differences in firm value and price. This is done directly by financial managers. For companies that are managed according to the system of added economic value, this problem is fundamental.

In the mid-1950s, the psychological theory of decision making under conditions of uncertainty was actively developing in the United States. She was the forerunner of directly behavioural finance.

First of all, psychologists paid attention to risky professions. In the 1960s and early 1970s, the Defense Advanced Research Projects Agency (DARPA) promoted the choice theory that would replace expected utility theory. It also funded the initial defence development of the Internet. The professions associated with financial risk began to be studied by psychologists in the late 1960s. A paper on the analysis of decision making on financial risks by brokers, written by Slovic (1972), was published in the *Journal of Applied Psychology*. Then the results of research on this work were published in the *Journal of Finance* (Slovic, 1972). It was from this moment that they began to study the interaction of finance and psychology. The impetus for the development of behavioural finance came from two articles written and published by psychologists Amos Tverskoy and Daniel Kahneman in the 1970s.

The last article was the most cited article ever published in the journal *Econometrica* and is still the case today.

The classic was an article by the economist at Yale University Robert Shiller, which was published in 1981. Shiller (1981), using empirical material, refuted the statement that the share price is equal to the present value of the expected future dividend stream. Shiller (1981) showed that the cost of dividends has been nearly constant over the past century, even though stock prices have varied in their amplitude.

There has been a debate in the financial economics community over this article. Shiller's next article turned out to be no less controversial. In it, he argued that fashion has a significant influence on

financial markets. Schiller's articles became the impetus for all kinds of empirical studies that recorded various anomalies in the financial markets.

The first application of psychological concepts to corporate finance came in 1984 when Hersh Shifrin and Meyer Statman used prospectus theory for explanation of the dividend mystery. Werner de Bondt and Richard Talyer published an article in 1985 that supported the hypothesis that cognitive errors lead to misjudgment of stock prices on the New York Stock Exchange.

The American Finance Association created the first section on behavioural finance in 1984. In 1985, the University of Chicago considered the "world centre for academic finance," sponsored the first conference to focus on behavioural finance.

In the United States, the National Bureau of Economic Research formed a working group in the 1980s. Research on behavioural finance peaked in the 1990s. Many new theoretical and empirical works have been published. Behavioural finance in the 90s is becoming the most "fashionable" area of financial research. Researchers argue that psychological phenomena play a considerable role in aspects of financial policy, in the pricing of financial assets, in corporate finance and derivatives.

7. Conclusion

Four main factors are the main building blocks of behavioural finance:

1. Heuristic errors.
2. Effects associated with shape dependence.
3. Prospectus theory.
4. Theory of ineffective financial risks.

It is also important to consider the firm's dividend policy in terms of behavioural finance. For this, it is necessary to consider the methods of behavioural finance that are used in the dividend policy of the firm.

First, consider the application of prospectus theory, which is one of the first behavioural studies in corporate finance.

In classical financial theory, it is said that dividends and capital gains should be interchangeable for each other. The payment of \$ 1 in dividend results directly in the same decline in the firm's share price. Consequently, an individual investor does not care how he receives \$ 1 in the form of dividend or capital gain because he can receive a "homemade" dividend by selling a share. Fischer Black expressed his attitude to the cash dividend of the classical school: "Suppose you have the following choice. People can get \$ 2 today and then have a 50/50 chance of getting \$ 54 or \$ 50 tomorrow. Alternatively, people may not get anything today but have a 50/50 chance of getting \$ 56 or \$ 52 tomorrow. Is there a difference between the two? Probably not. Aside from the \$ 2 interest, there is no difference between the two options".

However, this does not take into account the impact of taxes. The tax on cash dividend payments exceeds the tax on capital gains for most investors. Therefore, it is rational for investors not to receive a dividend as long as the firm has the opportunity to invest in capital projects. Nevertheless, many investors will still prefer to receive cash dividends. There is the following case in the scientific literature. President of General Public Utilities Corp. offered to replace the cash dividend with additional shares in the

company and offered to help sell the received shares with minimal brokerage costs to all shareholders who would like to receive cash income equivalent to income from cash dividends. According to the firm's estimates, direct tax savings for shareholders were no more than \$ 4 million annually. The firm itself would receive no more than \$ 20 million in savings annually. However, most of the shareholders of the firm rejected the offer, and their reaction was very hostile. As a result, the plan to replace the cash dividend with a share dividend was cancelled. This attitude to dividends among shareholders is no exception.

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