Risk of Risk Avoidance In Firm Decisions: A study of Emerging Market

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Abstract

The positive return on capital expenditure decisions can cause firm value to mount for the interest of owners in a rightful way. Conversely management sluggish feedback toward capital expenditures decisions can augment the risk of losing future positive returns. The core idea of this study is to work on the biased perception of managers for capital expenditure decisions of firms under the moderating effect of culture targets Pakistani firms. Indirect Effect has been observed by mediation analysis in SPSS and Process by Hayes after data collected via survey. The results suggest that effect of conservatism bias is significantly mediated by risk perception of executives for capital expenditure decisions.

Key words: Conservatism Bias, Risk Avoidance, CED

Introduction

Risk aversion is normally understood in economics as study of decisions by avoiding uncertainty. On the other hand risk-seeking choices are time and again observed in two programs of decision problems. First, group of people frequently choose a little probability of winning a big prize over the anticipated value of that prospect. Second, risk seeking is established when one has to decide among loss and a substantial probability of a bigger loss. The third generation prospect theory further extends the knowledge toward risky prospects of choices and judgments (Birnbaum, 2018).

Behavioral Finance

Different researchers has put forward their advices both practically and hypothetically for the efficient market hypothesis. Behavioralists signals the shortcomings in financial marketplace to the mixture of cognitive biases e.g. overconfidence, conservatism, information bias, and a range of new conventional human disparities in judgments. Despite the fundamental role the risk plays in agency theory, Wiseman & Mejia, (2016) quoted that agency theory foundation of risk is limited i.e.

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According to the behavioral economists agency model views risk averse and compensated risk behavior of managerial decisions as essential element of investigation but it pay no heed to risk seeking behavior of managers (Wiseman & Mejia, 2016).

Study Objective

Main goal of this work is to target the two basic theories i.e. Prospect theory & agency theory for managerial decisions particularly Investment decisions and further link it to the unexplored areas all together. Study found the gap in the area of executive's behavioral biases and advanced the behavioral disparity strings in the direction of executives risk perception which in turn arbitrate its upshot to the executive's decisions. Authors of existing time including Bairagi & Chakraborty (2018) have challenged the previous scholar's work by working on risk taking behavior of managerial decision making.

Literature Review

Kahneman and Tversky thought of cognitive biases, and these biases' impact on judgments got famous when in 2002 Kahneman was honored with a Nobel Prize in the area of economics. Previous scholars put efforts toward cognitive dissonance theory and set up the thought that financier cognitive choices may be biased (Konow, 2000). Detailed literary support is provided as follows

Conservatism Bias

Conservatism bias is a intellectual practice in which people adhere to their past vision or forecasts at the cost of recognizing novel information. Ritter, (2003) said that changed situation may affect people to react slowly. He further added that this under reaction is because of conservatism bias. Conservatism bias has been explored recently by authors in Pakistan and found various dimensions to be explored further where Rahim, Shah & Amir, (2019) found significant impact of conservatism bias on investment decisions in Pakistan.

Manager Capital Expenditure Decisions

Under the umbrella of fundamental goals and principles of the organizations executive's capital expenditure decision is inspired by 03 crucial objectives: (1) maximisation of owner's wealth (2) liquidity arrangement, & (3) risk diminution (Obamuyi, 2013). Masomi & Ghayekhloo (2011) assured that capital expenditure decisions of directors should aspire ideology of maximization of owners wealth, self-regard and reliable alternative selection. Current study targets Conservatism bias to examine their effect on managerial decisions.

Conservatism Bias and Capital Expenditure Decisions

Literature is filled with vast efforts by prior instigators concerning conservatism bias capital expenditure decisions. Luu in 2014 worked on conservatism bias for investment decisions of managers and broaden the information vicinity around conservatism bias by arguing that it can be linked to the idea of disposition effect which is the inclination of administrators to sell winners soon and hold looser for long period (Luu, 2014).

*H1***.** Conservatism Bias is negatively related to CED

Behavioral Biases and Risk Perception

According to Li, Lin & Haung, (2018) overconfident CEOs also strive to ease risk but actually they underrate the risk and resultantly faced with inexplicable episodes. Vice versa is the case of conservative CEOs who overrate the risk and react conservatively to judgments and may results into less optimal results. Research ropes the thought that cognitive heuristics create inconsistency among CEO's risk perception and behavior (Kuo, 2018).

H2: Conservatism Bias is positively related to Risk Perception

Risk and Firm Decisions

Risk holds a constructive term with asset choice for optimistic returns perhaps it can be depressingly associated with the decision choice in the situation of higher losses (Khan, 2015). Mirza et. al. added to knowledge by signalling toward the risk inclination as major aspect to seize or evade risk in judgments (Mirza et al, 2019). This thought has been confirmed by Naz & Ayub, (2018) with their work in Pakistan where they found that an investment's likely risk and gain symbolizes the hazard innate in that project.

H3: Risk Perception is negatively related to CED

Risk Perception among Conservatism Bias and Firm's CED

Sarwar & Saeed, (2013) worked in Pakistan on the role of risk perception as a mediator and projected that risk perception act as a mediator for executive's decisions which involve risk. Explorers linked the risk perception's prejudiced part toward risk captivating or danger averseness of Pakistani companies' executives (Hamid et.al, 2013). Explorers further spread the roots of their work and concluded that Pakistani manager's biased behaviours and their decisions are mediated by their risk perception (Riaz , Hunjra & Azam, 2012, Muneer et al., 2017). Ullah, Shivakoti, & Ali, (2015) worked on the risk allied behavior of CEOs working in Pakistan and established that risk perception is a determining factor of risk.

H4. Risk perception significantly mediates the relationship between Conservatism Bias and CE.

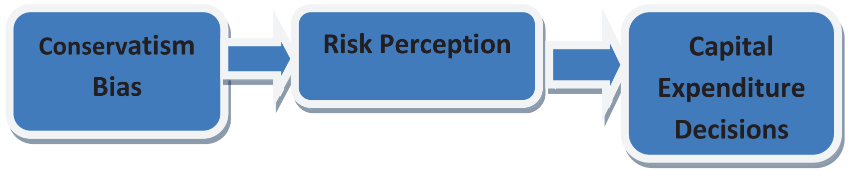

Fig 1: Theoretical Framework

Research Methodology

Research Design

This research work is completed through survey based data collected from executives of non financial firms listed at PSE. Questionnaire considered was taken at 07 point likert scale while mediation analysis was done by using Process by Hayes. The survey work was conducted through convenient sampling and targeted firm's from Pakistan including Punjab (Lahore, Gujranwala, Sialkot, Multan), KPK (Peshawar, Haripur) & Sindh (Karachi, Hyderabad).

Measures Validity

Validity of measures was confirmed through discriminant and convergent validity. Chronbach Alpha for the variables was as folllows i.e. For conservatism bias it was 0.75, Capital Expenditure Decisions chronbach alpha was 0.80

Data Analysis

Descriptive Statistics & Correlation

Descriptive statistics is specified for all the variable, which consist of mean , SD, correlation reliability. i.e. Value for Mean of Capital Expenditure Decision (CED) was (M=3.78, S.D=1.74), Agent's Risk Perception (ARISKP) (M=3.21,S.D=0.97). Results confirms that CONSB has negative correlation with INVD (r= -.42).

Mediation Analysis

Conservatism Bias on CID via Risk Perception

Results demonstrate positive connection among CONSB and ARISKP i.e. (β = 0.61., p< .001). Results further show negative association for ARISKP and CED i.e. (β = -0.10, p< .001). While under the direct effect negative relation was found among CONSB on INVD (β = -0.02, p< .001). There was no zero among the upper as well as lower limits of boot strap confidence interval i.e. 0.07(-0.0,-0.10). Results confirms indirect significance for Capital Expenditure Decisions under Sobel test (Sobel z=1.30, p<.0.00).

Table 1 Regression Results for Direct effect and Indirect Effect

	Direct and Total Effects			
	B	S.E	T	P
Agent Risk Perception on Conservatism Bias MED on IV	0.61	0.07	-8.43	0.00
Investment Decision on Agent Risk Perception DV on MED	-0.10	0.02	3.30	0.00
Investment Decision on Conservatism Bias DV on IV	-0.02	0.01	1.28	0.00
Bootstrap Indirect result of IV on DV through MV (Bias corrected CI)				
	Effect	Boot S.E	LL95%CI	UL95%CI
	0.08	0.01	-0.20	-0.10
Sobel Indirect result using normal Distribution				
	Effect	S.E	Z	P
	0.08	0.01	1.30	0.00

sample size = 5,000. LL = lower limit; CI = confidence interval; UL = upper limit

Results And Discussion

Current study proposed 4 hypothesis out of which all 4 are accepted. Conservatism bias has significant relationship with capital expenditure decisions. Furthermore conservatism bias is significantly related with risk perception. Where Pakistani managers avoid decisions due to their conservative behaviors.

Conclusion

Study concludes regarding the significant function of risk perception for conservatism bias of CEOs and target firms capital expenditure decision. The findings suggests to conclude that managers while making firm's capital expenditure decisions in Pakistan are more prone to follow the conservative path which is mediated by the risk perception of these agents/mangers. If the firm's system is capable to comprehend the traits of CEOs/managers then it can better handle the agency issues and increase the worth of its shareholders wealth (Shaikh, 2019).

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