Journal of Positive School Psychology http://journalppw.com
2022, Vol. 6, No. 12, 1327-1337

The Effect Of Overconfidence Managerial And Corporate Governance On Internal Financing: Evidence From Manufacturing In Indonesia

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Abstract
This study aims to examine the effect of managerial overconfidence and corporate governance on internal financing. The research population is a manufacturing company listed on the Indonesia Stock Exchange. Sample determination using purposive so that the research sample amounted to 264 observation data. The research data were analyzed using smart PLS version 3. The result of the study is that managerial overconfidence has a positive and significant effect on internal financing. This shows that managers view the profit earned as a result of their performance so they prefer to hold as retained earnings rather than distributed to shareholders as dividends, The availability of funds in the company will make it easier for managers to fund the company's activities, besides that managers who are overconfident view external financing in the future as more expensive than internal funds so as to restrain profits, this is done because managers who are overconfident want to avoid risks arising from external financing. Meanwhile, corporate governance has a positive but not significant effect on internal financing. This shows that when shareholders feel that their rights are well protected, they are more willing to let companies with good growth opportunities maintain their retained earnings, because they are confident that they will share the results of a good project in the future.

Keywords: managerial overconfidence, corporate governance, internal financing.

I. Introduction

The decision function in financial management can be divided into three main areas: investment, financing and asset management (Van Horne & Wachowicz, 2009). Meanwhile, according to Brigham & Houston (2019) that finance is divided into three areas: (1) financial management, (2) capital markets, and (3) investment. In relation to the main areas of finance, the focus of research is related to investment and financing decisions, especially internal financing. Overconfidence is a typical irrational behavior and that company managers tend to show it when they make business decisions (Roll, 1986). According to Malmendier & Tate (2005) that overconfidence can influence important company decisions.

Managerial circles that have overconfidence tend to hold profits as retained earnings rather than paying dividends to shareholders (Deshmukh et al., 2013). Managerial overconfidence tends to increase internal financing, internal financing becomes the main source of financing and investment becomes more efficient (He et al., 2019). This is because internal funds have a low cost of capital, and internal funds are obtained from the performance of managers. Previous research on the effect of managerial overconfidence on internal financing found positive and significant

influences (Aktas et al., 2019; Yang & Kim, 2020). On the other hand, other studies have found that managerial overconfidence has a negative and significant effect on internal financing (Ben et al., 2016; Y.-R. Chen et al., 2020). Managerial overconfidence ignores financial losses resulting in issuing high debt.

From the perspective of behavioral finance, company managers tend to choose internal financing over other sources because managers have more control over internal funds. Companies that have overconfidence managerial will overinvest with internal funds (He et al., 2019; Malmendier et al., 2011). Thus, according to He et al. (2019) in a study in China recommends to subsequent researchers to add corporate governance variables so that company investment becomes more efficient.

Governance mechanisms are designed to address the problems of inefficient allocation of resources through the supervisory roles of the board of directors, board of commissioners and large shareholders. Investors' belief about the company that managers and shareholders will not shift their investments to unproductive goals, thus the existence of a strong corporate governance mechanism is required (Naeem & Li, 2019; Shahid & Abbas, 2019). The implementation of corporate governance creates confidence for the company, especially for shareholders.

Corporate governance has a positive and significant impact on the company's internal financing (Rodrigues et al., 2020; Zhou et al., 2021). However, other studies have found that corporate governance negatively affects internal financing (Atanasova et al., 2016; Musa et al., 2015). This shows that strong governance prefers to pay dividends to shareholders rather than as retained earnings because it avoids conflicts of interest between managers and shareholders.

Companies that have strong governance can increase the company's investment by using internal funds, because shareholders want to get returns in the future than at present as well as investors believe that with strong governance, the funds invested can be allocated to projects that have a positive NPV so as to improve the welfare of shareholders (Atanasova et al., 2016; Shamsabadi et al., 2020). On the other hand, other research findings found that there is no effective corporate governance mechanism that can help reduce significant sensitivity between free cash flow and investment (X. Chen et al., 2016; Shi, 2019).

II. Literature Review

2.1. Overconfidence Managerial

Irrational behavior can be divided into two groups: theories of cognitive bias (Festinger, 1962) and prospect theory (Kahneman & Tversky, 1979). The basic idea of cognitive theory is that the behavior of the individual is determined by his own thoughts, that is, contemplation and self-perception determine behavior and emotions (Beck, 2008). On the other hand, prospect theory describes how investors view gains and losses. Kahneman & Tversky (1979) state that people see gains and losses differently and losses make a greater emotional impact on investors than profits.

Attribution theory explains the process of how to determine the causes and motiv about a person's behavior (Heider & Weiner, 2002). This theory refers to how a person explains the causes of the behavior of others or himself which will be determined whether from internal for example traits, characters, attitudes or external or certain circumstances that will influence the behavior of the individual. Attribution theory explains the understanding of a person's reaction to the events around them, by knowing their reasons for the events experienced. Attribution theory explains that there are behaviors related to the attitudes and characteristics of the individual, so it can be said that just looking at his behavior will be able to know the attitudes or characteristics of the person and can also predict a person's behavior in the

face of the situation (Heider & Weiner, 2002). Internal forces such as: ability, effort and tenacity and external forces together determine human behavior.

The Theory of the Upper Echelon states that the nature or characteristics of the managerial background estimate the results of the organization, the planned choice and the level of performance (Hambrick & Mason, 1984). The theory further suggests that the more complex a decision is, the more important the personal characteristics of the decision maker, such as: age, length of service and specialization, since the behavioral components and privileges of the decision maker, such as cognitive basis and value preferences, this generates many strategic options (Chuang et al., 2009). In other words, the theory of the upper echelons recognizes that the different characteristics of top managers such as age or career experience influence their decisions on strategy and structure and will directly affect the strategic choice of the company and the performance of the organization (Nielsen, 2010).

Overconfidence is the act of exaggerating knowledge, belittling risks and exaggerating their ability to control events (Baker & Nofsinger, 2010). The discovery of overconfidence is one of the most powerful findings in the field of psychology about decision making (De Bondt & Thaler, 1995). Overconfidence is generally a cognitive bias, reflecting the possibility of exaggerating one's ability to complete tasks and belittling one's chances of losing one's job (He et al., 2019). Managerial overconfidence is managers who overestimate their capabilities and the future performance of their company (He et al., 2019). Managerial overconfidence is the tendency to judge for yourself the knowledge, capabilities and accuracy of information, and at the same time, underestimate adverse outcomes and risks (Phan & Nguyen, 2020).

2.2. Corporate Governance

Jensen & Meckling (1976) explain the agency relationship in agency theory that a company is a collection of contracts (nexus of contract) between the owner of economic resources (principal) and the manager (agent) who takes care of the use and control of these resources. This agency relationship results in two problems, namely: a) the occurrence of asymmetry information, where management generally has more information about the actual financial position and operating position of the entity from the owner; and, b) the occurrence of conflicts of interest due to inequality of purpose, where management does not always act in accordance with the interests of the owner.

In an effort to overcome or reduce agency problems, this creates agency costs that will be borne by both principals and agents. Jensen & Meckling (1976) divided these agency costs into monitoring costs, bonding costs and residual losses. Monitoring costs are costs incurred and borne by the principal to monitor agent behavior, namely to measure, observe, and control agent behavior. Bonding cost is the cost incurred by the agent to establish and comply with the mechanism that guarantees that the agent will act in the interests of the principal. Furthermore, residual loss is a sacrifice in the form of reduced principal prosperity as a result of differences in agent decisions and principal decisions.

Corporate governance refers to internal and external mechanisms that reduce agency conflicts arising from the separation of ownership and control (Shleifer & Vishny, 1997). This mechanism aims to guarantee investors in the return on their investment (Shleifer & Vishny, 1997), while avoiding expropriation by insiders (La Porta et al., 2000). Corporate governance is a system by which a company is directed and controlled. It describes the rights and obligations of all stakeholders of the company (Aoki, 2000). Corporate governance is a set of standards and rules that supervise and control the decisions of managers within the company to resolve conflicts

arising between principals and agents, this can significantly reduce the cost of information (La Rocca, 2007).

Corporate governance is a system of allocating the proper distribution of corporate responsibilities to the principles governing the properties of management and decisions in a company. Corporate governance is a system by which business companies are directed and controlled (Musa et al., 2015). The corporate governance structure determines the distribution of rights and responsibilities among different participants within the company, such as the board, managers, shareholders and other stakeholders and details the rules and procedures for making decisions in the affairs of the company. Corporate governance is the management of the principles of openness, honesty and management responsibility to shareholders, employees, suppliers, customers, banks, regulators, the surrounding environment and the environment.

2.3. Internal Financing

The pecking-order model states that when managers have valuable information, they should have a preference for internal rather than external capital because the market is unlikely to underestimate internal equity. According to Myers & Majiuf, 1984), managers having personal information about the prospects of the company they have to spend on internal sources before raising external capital, first with debt then with equity. Researchers generally refer to this model as an asymmetric information model because of the difference in information between company insiders and outsiders.

The theory of pecking orders states that asymmetric information and signaling problems related to external finances create a hierarchy of financing options of the company, that is, to use internal funds and safe debt first, then use risky debt, and finally switch to external equity. The driving force behind the pecking order theory of corporate financing decisions, as suggested by Myers & Majiuf (1984), is that managers know more about the prospects, risks, and value of their companies than outside investors. In the face of information asymmetry, managers' attempts to issue risky securities tend to be interpreted by outside investors as a signal that the company is overvalued.

Internal financing is a way of spending companies that use funds that are not distributed to shareholders or what is commonly termed as withheld funds. After the company's profit minus income tax is obtained Net Profit. After tax which will then be distributed to shareholders as dividends and/or withheld in the company. The retained portion within the company is an internal source of financing within the balance sheet, including part of the shareholders' capital or funds. Internal financing is the availability of funds withheld. The size or size of internal financing depends largely on the size and size of dividend payments, the larger the dividend paid, the smaller the dividend that can be reinvested.

III. Hypothesis Development

3.1. The effect of managerial overconfidence on internal financing

Attribution theory explains the process of how to determine the causes about a person's behavior (Heider & Weiner, 2002). This theory refers to how a person explains the causes of behavior determined by internal aspects such as: traits, characters, attitudes and external aspects or certain circumstances that will exert an influence on the behavior of the individual. Attribution theory also explains how a person reacts to the events around them, by knowing their reasons for the events experienced.

Research by Ting et al. (2016) concludes that: first, the CEO's overconfidence is significantly and negatively related to the company's financing decisions; second, a higher level of managerial trust will result in lower

leverage. He et al. (2019) research found that managerial overconfidence has a positive and significant effect on internal financing. Managerial overconfidence is more likely to increase internal financing, as internal financing becomes their main source of financing and investment becomes more efficient. Overconfident managers are less likely to pay dividends and withhold revenue as profit is held for company financing. Thus the research hypothesis:

H1: Managerial overconfidence has a positive and significant effect on internal financing

3.2. The effect of corporate governance on internal financing

The board of directors is one of the most important elements of the corporate governance mechanism in overseeing the effectiveness and appropriate operations of the company. It plays an important role in reducing corporate failures (Chancharat et al., 2012). The board of directors is also responsible for monitoring key activities and approving strategic decisions. There are no clear guidelines on the appropriate size of the board. It has been suggested that the optimal size of the board depends on the characteristics of the enterprise, the cost of monitoring and the complexity of the organization (Uchida, 2011). On the one hand, Berger & Humphrey (1997) show that the size of the board of commissioners negatively affects financial leverage.

Zhou et al. (2021) examine the relationship between corporate governance and financial leverage in non-financial companies in China during 2000-2018. Empirical results show that improving the quality of corporate governance has a strong and negative influence on leverage. This negative effect shows that strong corporate governance will direct internal financing in financing the company's activities. Atanasova et al. (2016) researching the relationship between corporate governance and dividend policy found that companies with weaker governance pay more cash dividends than companies with better governance. It also found that, with low-quality governance, dividend payments reduce the value of the company as well as the value of the company's cash holdings. This means that when the company implements better governance, the profit earned by the company is mostly used as retained earnings to be reinvested rather than paid dividends for short-term benefits. Thus the research hypothesis:

H2: Corporate governance has a positive and significant effect on internal financing

IV. Measurement and data

4.1. Measurement

In this study, the independent variables are (1) managerial overconfidence, with measurements: a) estimated income (He et al., 2019; Huang et al., 2016), b) profile photo of directors (Ting et al., 2015). Revenue forecast measurement is a revenue forecast calculated in a regression model as a prediction of income or actual income minus the residual, further measured by the natural logarithm of the predicted income. While the profile photo of the directors is the percentage of the size of the board of directors' photo on the annual report page. (2) corporate governance, with measurements: (a) board size, (b) independent board and (c) joint meetings between the board of directors and commissioners which are proxies of corporate governance. While the dependent variable is internal financing, with measurements: retained earnings (Bilicka, 2020; He et al., 2019).

4.2. Data

The research population is a manufacturing company listed on the Indonesia Stock Exchange. Based on the criteria in determining the sample, the final sample amounted to 44 companies with a total of 264 observations. Research data is secondary data, namely data presented in the

company's annual report obtained from the website of each company or the website of the Indonesia Stock Exchange.

V. Result

5.1. Descriptive Analysis

Descriptive analysis displays the average value (mean), maximum value and minimum value of each indicator used in the research variable, the indicators used include: estimated income and the size of the board profile photo as a measurement of the managerial overconfidence variable; Retained Earnings as a Measurement of Internal Financing Variables. Descriptive statistical values can be displayed in the following table:

Table.1 Descriptive Statistics

	N	Minimum	Maximum	Mean	Std.Deviation
Profit Forecast	264	-12.25	17.01	10.50	5.97
Photos of the directors	264	.20	1.00	.60	.29
Board size	264	2.00	16.00	5.52	2.67
Commissioner size	264	2.00	12.00	4.53	2.09
Independence commiss	264	.17	.80	.40	.10
Joint meeting	264	2.00	14.00	5.93	3.22
Retained earnings	264	-.08	.86	.36	.22
Valid N (Listwise)	264				

Table1 shows that the mean values of all indicators are greater than the standard deviation values. This indicates that the current mean value indicates a good representation of the overall data.

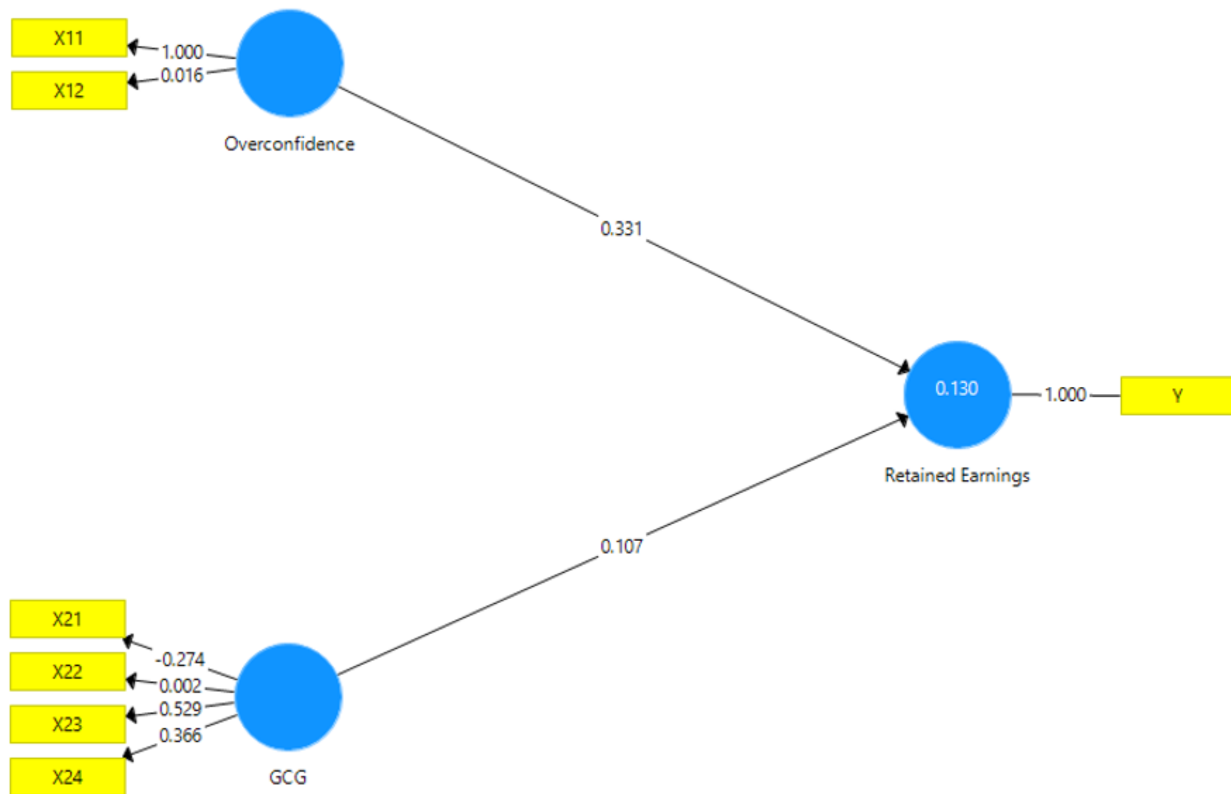
5.2. Inferential Statistics

The value of the path coefficient as presented in table 2 shows that the managerial influence of overconfidence on internal financing with a path coefficient value of 0.331 and a p-value of 0.000 or significant at the level of 1%. This shows that managerial overconfidence has a unidirectional effect and contributes significantly to internal financing. Meanwhile, corporate governance has a positive but not significant effect on internal financing.

Table2: Path Analysis

	Original Sample (O)	**Sample Mean (M)**	**Standard Deviation (STDEV)**	**T Statistics (|O/STDEV|)**	**P Values**
GCG -> Retained Earnings	0.107	-0.041	0.147	0.726	**0.468**
Overconfidence -> Retained Earnings	0.331	0.354	0.041	8.054	**0.000**

Figure1: Empirical Models



VI. Discussion

The coefficient of managerial overconfidence path to internal financing is 0.331 and p-value is 0.000 or significant at the level of 1%.This shows that managers who are overconfident view that the performance achieved in the form of profit, is preferred to be recorded as retained earnings rather than distributed to shareholders as dividends, because the availability of funds in the company will make it easier for managers to fund the company's activities. In addition, managers who are overconfident view external financing in the future as more expensive than internal funds, thus reducing dividend payments, this is done because managers who are too confident want to avoid risks arising from external financing. Empirical studies show that overconfident managers pay lower dividends than rational managers. The results of this study support the research that overconfident managers tend not to pay dividends and withhold income as profit on hold for company financing (Deshmukh et al., 2013; He et al., 2019).

Corporate governance path coefficient to internal financing with a path coefficient of 0.107 and p-value of 0.468. The results showed that the positive but not significant. The results showed that the stronger the corporate governance, the proportion of retained earnings increased, but those who carried out the strategy of holding profits were dominated by large companies, because they wanted to get a greater profit in the future. This means that strong corporate governance requires that the profits earned by the company be greater than distributed to shareholders as dividends.

Strong governance and monitoring of managers means shareholders do not require regular dividend payments. This is due to the fact that they are more confident that managers are acting in the interests of shareholders. However, when governance is weak, managers must pay dividends regularly to reassure shareholders that they will not take over their investments (Atanasova et al., 2016). Strong corporate governance mechanisms are able to reduce

agency costs. Managers tend to look for lower financial leverage when they are dealing with good corporate governance from the board of directors (Wen et al., 2002).

VII. Conclusion

This study examines the effect of managerial overconfidence and corporate governance on internal financing. The study was conducted on manufacturing companies listed on the Indonesia Stock Exchange. Based on the specified criteria, the research sample amounted to 246 data observed. The results showed that managerial overconfidence has a positive and significant effect on internal financing. This shows that the availability of funds in the company will make it easier for managers to fund company activities, besides that managers consider that the profit obtained is the result of their performance so that managers are more restrained than used as dividends. Meanwhile, the influence of corporate governance on internal financing is positive but not significant. This shows that strong governance and monitoring of managers means that shareholders do not require regular dividend payments. This is due to the fact that they are more confident that managers are acting in the interests of shareholders.

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