

# CLASSICAL MANAGEMENT BIASES AND BEHAVIORAL APPROACH COMPREHENSION

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**Abstract:** *The article at the outset conducted on the theoretical basis, incorporating relevant authors and theories, has pointed to a number of weaknesses of neoclassical theory, which would be hardly compatible with real management practice and manager behavior. Article critically evaluated theoretical background in management sciences and examined manager in behavioral and heuristic theories. Analysis offered an interpretation of managerial decision-making as a product of personal preferences and characteristics, limited rationality, lack of information, mental shortcut, and imitation. Analysis described practical behavior of managers and then correlated these to each other and to explanatory factors as well. The re-orientation towards recognition of managerial behavior is developed and illustrated. Conclusions were derived from the generalization of empirical observations. Empirical research is based on in-depth qualitative study and subsequently it derives from established theoretical patterns. It explores and explains the way managers make economic decisions. The emerging theory strongly emphasizes the strengthening of the human potential inside a manager.*

**Keywords:** *Management, Behavioral Management, Manager's Decision-making, Heuristics, Qualitative Research.*

**JEL Classification:** *D81, D91, L2, M1.*

## Introduction

Management theory has taken various paths of development in recent years. Increasing number of discussions on management pivots around the ideas of manager's competencies and capabilities, personal preferences and characteristics, limited rationality, lack of information, knowledge-creating and other managerial routines, decisions, and behavioral practices. Handling disadvantages and acquiring capabilities are crucial for the ability of a firm to function. New ideas featured in this article by investigating the behavioral patterns of managers can contribute to update the classical theories.

## 1 Theoretical background

### 1.1 Classical theory of the firm, its characteristics, biases

The neoclassical theory of the firm has grown on quite orthodox opinions on the functioning of firms and the role they play on the market. The traditional understanding of firm theory is based on the assumption that it is based on the profits maximization, and that it is the only and main goal. Hence, management of the firm is pursuing profits, this single goal. Therefore, it does not allow anyone in the firm management to pursue a different goal than the firm's profit.

It can be said that the theory meets the goals for which it was created. It serves to understand the behavior of the market as a whole, to explain the impact of certain factors like changes in market prices, to which this theory is sufficient, and its

shortcomings are not important. This simplified theory of the firm, represented by Drucker (2008), Koontz and Weihrich (2015), makes it easy to understand the economy as whole.

The neoclassical theory of the firm assumes that the owner of the business is also a manager at the same time. Theory unites the one who bears the risks of doing business and puts his money into it with the one who manages a firm. Owner and manager as one person signs for all contracts for the firm's activities and decides about its future business orientation. In the case of a one-man firm, it is possible that the owner itself will control the firm. However, merging of ownership and management of the firm is not a way of management in practice. Nowadays, it is quite common to own a firm but not to manage it at the same time.

Another factor that is not sufficiently taken into account by the neoclassical theory is the manager's control and oversight of the firm's activities. Today dominate the kind of companies where ownership is separated from control. These are firms or entities in which control and management are entrusted to the firm's board of directors, which is composed of owners, but also of other management personnel.

Biases of the neoclassical theory can be summarized, that it looks at a firm purposely in a very specific way in order to explain easily various changes caused by multiple factors.

## **1.2 Classical versus behavioral theories**

According to the classical theory of the firm, companies solve problems by identifying a given problem, then setting up different solutions, from which they then select and implement the best possible solution. Neoclassical theory is based on the assumption that managers have the maximum available information and all accurate and up-to-date calculations. However, this situation in today's market can hardly ever happen.

According to the behavioral theories, managers simplify their decision-making process. They set short-term goals and look for alternatives to solutions that would satisfy these goals, rather than focusing on finding one best possible solution. Rather, they achieve targets gradually, even with the risk of potential loss as a result of choosing the wrong alternative of choice. Above all, they try to make rational decisions, use human behavioral approach to follow decision-making processes.

The neoclassical theory is based on the fact, that all entities in the company pursue only one goal, maximizing profit, as an unchanging fact. The theory considers the assumption that there are many entities inside the firm with different, often conflicting interests. The neoclassical theory acknowledges the fact that managers may have their own private interests but at the same time, theory assumes that they will either voluntarily ignore them or that a possible conflict of interest between the firm and manager will be covered by employee contract.

Behavioral theories take the opposite view. They assume that there is a constant conflict of interest between the firm and other entities. The permanent conflicts of interests among owners and managers are subject to speculation and action in the firm. This conflict will never disappear and must be solved over and over again. It is therefore a major problem to identify an unambiguous firm goal as each side has a

different interest. According to behavioral theories, the coherence of the interests inside the firm is rarely achievable and difficult to sustain.

Behavioral theory takes into account the human factor that has according to Šebestová (2007) a major influence. It examines not only the behavior of the firm, but also the behavior of particular individuals like hired managers.

### **1.3 Behavioral theories**

Behavioral theories are alternative theories of a firm that explain the behavior of individual firms. They look for the factors that affect the business, its management, the firms' decision-making, and the goals it pursues. They were founded in the 1960s on the assumption that the maximization of business profits is not the only target function of the business. In 1963, Cyert and March, one of the earliest experts in economic research work on behavioral theories, defined the main ideas underlying behavioral theories, and the authors themselves led to their practical validation.

Theory of limited rationality comes from observation that rational factors in decision-making are significantly limited by the amount of information available. Businesses are run by managers, who have complex relationships with business owners, which may be individuals, a group of people, or other businesses. This creates a complex ownership and managerial structure, bringing together organizational and communication problems that complicate the transfer of information. This causes lack of information, as it is not always possible to decide and manage accurately and timely. To make calculations is often costing and time consuming.

Cyert and March (1963) set out the main goals of behavioral theory. They clearly defined what the behavioral theory serves for. Authors have validated theoretical background by comparing theoretical assumptions with observations in different companies.

Behavioral theories display and explain how the firms and their management decides. It seeks to specify a set of rules and motivation assumptions that could be used to describe the manager's individual decisions.

Based on this, behavioral theories try to identify the possibilities for individual manager to make decisions. Based on the firm's goals, the theory specifies a set of management decision-making rules related to production, price, customers, costs, suppliers, and location. Management decision-making takes account of firm process optimization, but at the same time puts emphasis on set goals.

## **2 Statement of a problem**

Neoclassical theory is insufficient and does not give a true picture of the reality surrounding the firms, it does not explain nature and principles of their management operation. The neoclassical theory does not take into account the factors like an ownership form, performance of control, decision making and managing under uncertainty conditions. The theory was not set in order to investigate and explain the behavior of individual firms or managers and to deal with their internal processes.

Because the neoclassical theory of the firm does not correspond with the reality, more and more theorists gradually began to present various alternative theories dealing

with the behavior and nature of the existence and management of the firm. One of these theories is the theory of behavioral management.

Managerial theories are based on the principle that a firm managed by hired managers can have a different goal than to maximize their profits. When the firm owner is not present in the firm and the person who manages and controls the firm has all powers, he can pursue alternative interests. These interests are different than the business owners have. Thus, the two sides in the firm are often in mutual conflict. They follow the interests important to them from their point of view. Neoclassical theories are in conflict with reality and therefore it is necessary to amend theories by empirical research and evaluate theory consequently.

The main aim of the study is to verify the adequacy of behavioral management theory by examining it in companies and compare the results achieved with other management approaches.

### **3 Methods**

Behaviorists proceed inductively, they do not examine how managers should behave, but rather how they really do. Conclusions are derived from the generalization of empirical observations. Behavioral method describes the behavior of managers and then correlates these to explanatory factors. Hence, this is the method of presented study when outcome hypotheses are created in the end of research.

Manager's behavioral variables are in large part about subjective perceptions and not precise measurements. Accordingly, behavioral variables are used. Managerial action variables are defined as follows: transaction costs, competitiveness, limited rationality, imitation, size, suppliers' availability, human resources, finance availability and location.

#### **3.1 Measurements**

Behavioral variables are based on the qualitative and quantitative research of entrepreneurs, micro and small firms, their behavior and their management. For some variables, it is difficult to express them numerically, so in these cases a scale of score we determined according to analysis of the qualitative sources, which is requirement for used statistical methods. (Yasai-Ardekani, 1986)

To that end study chooses a qualitative research method, which involves the collection and analysis of qualitative data.

Qualitative research proceeds inductively and statements are generated only during the research as part of trying to understand a new problem. The reason for choosing the qualitative method here is that this issue is quite complex. The main benefit of the method is to provide in-depth insight into 54 enterprises.

#### **3.2 Data collection**

The investigated 54 firms come from the Pardubice region. The numbers of SMEs in the Czech Republic and in the Pardubice region (Zpráva o vývoji malého a středního podnikání a jeho podpoře, 2018) were identified. The research was carried out over the past five years, mapping 20 years of history of the individual business. Interviewed managers are a versatile group of people, all with valuable and

comprehensive insights of their firm's genesis, development and daily problems. Direct personal confrontation with the examined object and repeated long term research is an argument for the reliability.

Managers and entrepreneurs were proud of the results they have reached and they were willing to share their experience in empirical research. They have described how they started the business and how it developed, mentioning environmental obstacles they had to face as well as inner processes and inner doubts they had to go through. Six of them were women, two of which were wholesalers and four hair salon owners. The sample fits with NACE structure, hence major proportion is metal production. Although at the beginning managers have lacked technical skills, know-how, business experience, and capital, they proved exceptional flexibility and hard work.

Respondents were recorded and then the text was literally transcribed. The framework of the interview was established, and questions were directed to crystallize the situations that evoked a need for a managerial decision and subsequent choice of action. Their dynamics and causal mechanisms were emphasized.

The interviews searched for links and moments that particularly affected the managerial decision. Case study text was analyzed and integrated properly by prevailing assumptions and their meaning taking into account theoretical background. Data were combined in order to identify links and lastly use the processed material to amend existing theory. Processed data were connected to relevant theories finding a match or mismatch to be in accordance with main one.

### **3.3 Statistical methods**

This measure was developed by Yasai-Ardekani (1989) and Kutner et al., (2005), used mathematical measuring analysis. In order to test effects of the management style and manager's behavior, a correlation is used.

A Pearson's correlation coefficient is used. A number displayed in a Tab. n. 1 indicates the extent to which two variables are linearly related. (Bryman, Lewis-Beck, 2003).

#### **Variables:**

As the representational variables for manager's behavior and his individual perception were chosen indicators following method of Soofi et al. (2000). These variables were analyzed, in order to explain and confirm basic correlations. Variables are dichotomous (except Size variable) and represent the factors as managers themselves perceive them. Qualitative managers' statements related to this topic were analyzed and for each firm there was set value 0 for NO answer or a value 1 for YES answer.

Variable Profit maximization represents management style where value 0 is aiming towards maximum profit and value 1 is aiming towards satisfactory profit level.

Variable Location represents the factor of the location choice, as the managers themselves perceive it. There was set value 0 for disadvantageous location or value 1 for advantageous location.

Variable Competitiveness expresses the ability of the manager to successfully identify, grasp and use the right opportunity for growth, to expand and improve and strengthen the market position of the firm towards competitors (Starzyczna, 2015). Value 0 is for weak competitiveness and value 1 is for strongly perceived competitiveness.

Variable Imitation comes when behavior of peer firms are mindlessly imitated by managers of other firms no matter how wrong they may be. For instance if the recent evidence suggest that competitors have made money by choosing certain possibility, others will do exactly the same, managers simply imitate. Value 0 is for no imitation practice, value 1 is for active imitation practice.

Variable Size was measured as the logarithm of the number of employees.

Variable Transaction costs is a cost in making an economic transaction, especially cost to get information. Many theorists like De Nisi (2011) define transaction costs as cost of time spent on contracting, etc. Value 0 is for perceived low cost and value 1 is for perceived high cost.

Variable Suppliers availability is also a dummy variable and shows limited availability of convenient suppliers in the region. For 0 there is a good availability, entrepreneur does not need to create supra-regional ties of suppliers; for 1 the businesses experience the lack of suitable suppliers and they have to look for them in the more distant environments or even abroad.

Variable Human resources displays limited availability of qualified employees in the region (Augier, Teece, 2006), (Dvouletý, 2017). For every firm there is determined value 0 or 1. Value 1 means that firm is not able to find enough qualified employees in the surrounding region and is forced to search for human resources at the supra-regional level while on the other hand value 0 confirmed that entrepreneur could hire all the employees only within the region.

Variable Finance availability represents rate of limited availability of the finance in the region. It is measured from the point of view of the entrepreneurs, who indicate the circumstances and the rate of availability of the various finance resources in the region. For better interpretation of the results of the analysis, this variable is as well expressed with dummy variable 0 and 1. Value 0 means that availability of finance is not limited and the level of available finance resources in region is satisfying while value 1 confirmed statement that the availability of finance resources if limited for the specific entrepreneur.

Variable decision under Limited rationality expresses the limited ability of manager to choose the optimal possibility out of several possibilities and decision making under uncertainty. Task optimization is taken into consideration. Value 0 is for perceived weak task optimization and value 1 is for strong task optimization.

## 4 Outcomes and results

Relationships between all the variables are displayed in the Tab. 1 through correlation coefficients, which express positive or negative deviation via plus or minus signs of the coefficient. There are also means and standard deviations. (Kutner, et al., 2005).

To replicate the procedure of Yasai-Ardekani (1989), his proposed research model was tested via correlation analysis. Correlations were calculated together with means and standard deviations are portrayed in Tab. 1. Higher means shows Size, lower means show Finance availability, Human resources, Transaction costs and Limited rationality.

As can be seen in Tab. 1, variables tested on bivariate correlations under 0,39 are bellow critical values. Higher correlations show variables Profit – Competitiveness, Size – Competitiveness, Suppliers availability – Imitation practices, Human resource management – Competitiveness, Limited rationality – Transaction costs.

**Tab. 1: Means, Standard Deviations, and correlations for all variables**

<i>Variables</i>	<i>Means</i>	<i>Standard Deviations</i>	<i>1</i>	<i>2</i>	<i>3</i>	<i>4</i>	<i>5</i>	<i>6</i>	<i>7</i>	<i>8</i>	<i>9</i>	<i>10</i>
<i>1. Profit maximization</i>	<i>1.80</i>	<i>0.89</i>	<i>1</i>									
<i>2. Location</i>	<i>1.48</i>	<i>0.64</i>	<i>.10</i>	<i>1</i>								
<i>3. Competitiveness</i>	<i>1.84</i>	<i>0.83</i>	<i>.39</i>	<i>.29</i>	<i>1</i>							
<i>4. Imitation</i>	<i>0.84</i>	<i>0.37</i>	<i>-.22</i>	<i>.16</i>	<i>-.08</i>	<i>1</i>						
<i>5. Size</i>	<i>2.60</i>	<i>1.83</i>	<i>.01</i>	<i>.00</i>	<i>.40</i>	<i>.01</i>	<i>1</i>					
<i>6. Transaction costs</i>	<i>0.56</i>	<i>0.50</i>	<i>-.02</i>	<i>.16</i>	<i>.31</i>	<i>.05</i>	<i>.12</i>	<i>1</i>				
<i>7. Suppliers availability</i>	<i>0.88</i>	<i>0.32</i>	<i>.06</i>	<i>.08</i>	<i>.08</i>	<i>.51</i>	<i>-.10</i>	<i>-.08</i>	<i>1</i>			
<i>8. Human resources</i>	<i>0.60</i>	<i>0.49</i>	<i>.37</i>	<i>.23</i>	<i>.43</i>	<i>.09</i>	<i>.13</i>	<i>.10</i>	<i>.20</i>	<i>1</i>		
<i>9. Finance availability</i>	<i>0.40</i>	<i>0.49</i>	<i>-.18</i>	<i>.15</i>	<i>.06</i>	<i>.13</i>	<i>-.20</i>	<i>-.10</i>	<i>.30</i>	<i>.17</i>	<i>1</i>	
<i>10. Limited rationality</i>	<i>0.52</i>	<i>0.50</i>	<i>.32</i>	<i>-.03</i>	<i>-.09</i>	<i>-.20</i>	<i>.28</i>	<i>.48</i>	<i>-.11</i>	<i>.20</i>	<i>-.20</i>	<i>1</i>

All correlations above 0,30 are significant at  $p < 0,05$  and all correlations above 0,39 are significant at  $p < 0,01$ . The number of observation is 54.

Source: own

Significance allowed to state outcome hypotheses:

H1 The more manager seeks to maximize profit, the more competitive is the firm.

H2 Bigger firm reaches better competitiveness.

H3 Suppliers' availability is high for firm with imitation practices.

H4 The firm that is able to manage relevant human resources is more competitive.

H5 With limited rationality of manager the transaction cost are growing.

## 5 Evaluation and discussion

The theory accuracy was verified examining the observed firms, deciding on management strategies, and subsequently compared with the original theories. Behavioral theory served as a tool for analyzing decision-making among several alternatives of business strategy. A large number of recommendations in the field of long-term management strategy are designed to influence decision-making principles

in various ways. On this basis, the theory is also used to deduce the likely consequences of alternative management strategies.

Evaluation comes from using the basic statements of the behavioral theory for describing the certain style of a management of individual manager (Cyert, March, 1963) and deducing behavior of a manager. Supposed behavior compared with actual observed manager's behavior allowed to create outcome hypotheses based on correlations (Mandysová, 2017).

Empirical research has proved that decision-making under conditions of uncertainty is a very common situation for every manager today. However, the neoclassical theory of the firm does not consider this, it assumes the perfect awareness of all market players. Every manager of every firm on the market searches for the most accurate information about their internal and external environment as a basis for their management decision-making. Internal information, such as business performance data, can be obtained relatively easily, while the availability of external information is not always easy. Research proved that it is largely dependent on the manager's ability to decide under limited rationality, to apply different methods and tools, such as imitation, postponing suppliers' payments, suppliers' quality diversification, market research, competition analysis, and customer analysis future trends estimates, etc.

According to research outputs managerial decision-making is enriched by new goal setting. Firm size influences its competitiveness. In a big firm, the profit maximization is the main goal. In smaller firm, for example, maximizing profit, production, rewards, etc., is replaced by an attempt to achieve a satisfactorily level with all objectives (Vodák and Strišš, 2005). Thus, there is some explanation of satisfactory levels for the managerial objectives, reducing and influencing managerial decisions made under limited rationality and causing transaction costs growth. Outcomes showed that company size and its growth enables to maximize profit, to deal more effectively with competitive pressures (Myšková and Doupalová, 2015) and to reach higher competitiveness. In supplier's policy, managers' behavior depends on personal preferences and imitation practices. This will ensure greater flexibility in dealing with perceived pressures.

At present, managers are forced to tackle increasing amount of new and complex challenges and tasks associated with market globalization, IT technologies, innovation, environmental requirements, advanced and high-level competition, and so on. Managers have to solve several problems at the same time and must therefore look for a comprehensive and original solution. The ordinary management procedures used before are inefficient, outdated, and are not suited to addressing the situation that the business is currently facing. One of the possible ways to tackle these new challenges is the heuristic approach. Managers decide following their personal preferences, decision-making according to Kahneman (2012) is a product of personal preferences and characteristics, limited rationality, risk perception. In accordance with Killingsworth et. al. (2016), managers use heuristics, they often meet satisfactory level and due to lack of information imitate and decide by mental shortcut.

## Conclusion

The method of analysis undertaken in this research allowed examining the management style as impact of individual characteristics and preferences. The analysis first conducted at the theoretical basis including relevant authors and theories, has pointed to a number of weaknesses of neoclassical theory, which would be hardly compatible with real practice and management' behavior.

The article linked manager's individual perceptions and actions to his specific response. It allowed greater precision. Attention in the research of manager's behaviour and decision-making was focused on actions and practices under limited rationality and insufficient information. It was proved that managers react sometimes in an inadequate way. Surprisingly, many choices of the decision can be used to mitigate the situation (Koráb, 2016). Managers' behavior as the frequency of changing ties is directly affected by the limited determinants such as availability of suppliers, human resources and finance sources.

The research integrated social and human factors, including values such as confidence, prestige, a feeling of home, insecurity, fear. Identifying the actual behavior and daily work, it creates a description of a manager's decision in terms of a specific series of semi-decisions used to reach a choice. It discovers inner mechanisms as well as their genesis and incorporates them into the classical behavioral theory of the firm.

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