

A Brief Inventory of Behavioral Influences on the subjective Risk Adjusted Discount Rates in Project Appraisal¹

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Abstract

Behavioral finance has emerged as a new paradigm in financial economics. It deals primarily with the influences of psychology on market finance and with market inefficiencies. The field of psychology, already very present in organizational psychology and decision-making, is slowly opening up applications in corporate financial decisions and more specifically in corporate finance techniques. Among these corporate finance decisions is the project evaluation decision or the investment decision. This is based on first calculating expectations and risk estimates and then making a decision. This paper looks at how psychology can influence on the calculation of risk estimates which are used to evaluate projects. We break down the risk factors used in project finance as the real time value of money, perceptions of inflation, market risk and Beta, financial risk and firm-specific risk and study some psychological factors which can influence each of these and why these may be important. The psychological factors we study in this paper include patience and impatience, optimism and pessimism, the notion of time in different cultures, inter-temporal differences/ dynamic inconsistency, inner tempo, achievement orientation, past or future orientation, addiction, frequency of evaluations, horizon / myopia, money illusion, loss aversion, values and lifestyles, agency problems, organizational decentralization, adverse selection, limited liability, venture capital firms, qualitative projects, example human capital, familiarity bias, confidence and hubris.

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