

CAN TWO BIASES BE BETTER THAN NONE? COMPLEMENTARITY BETWEEN CEO OVERCONFIDENCE AND ACCOUNTING CONSERVATISM

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Synopsis. We study the joint effect of CEO overconfidence and accounting conservatism on firm performance and value. Successful innovation involves trial and error. An overconfident CEO is more willing to initiate daring investment projects, but also subjects the firm to excessive risk. Accounting conservatism (also referred to as *prudence*), on the other hand, accelerates the recognition of bad news, giving managers additional time to search for creative solutions that could not be anticipated before the project was undertaken. The theory of innovation, therefore, predicts that CEO overconfidence and accounting conservatism are complementary, i.e., the presence of both biases improves the firm's performance relative to the baseline case, especially if the firm operates in a dynamic, fast-changing environment.

Data and empirical design. To ensure that our data sources are reliable, we study the US-listed firms and use publicly available data sources (primarily the CRISP and Compustat data files). We use several measures of CEO overconfidence and accounting conservatism that have been proposed in the literature. Our empirical proxies for overconfidence are based on the stock option exercise behavior (e.g., Ahmed and Duellman 2013), press coverage (e.g., Hribar and Yang 2014), net insider purchases of the firm's shares (e.g., Campbell et al. 2011), and capital investment (e.g., Schrand and Zechman 2012). We follow Khan and Watts (2009) to construct a firm- and year-specific measure of accounting conservatism.

Results and discussion. Our empirical tests confirm the theoretical prediction. We report that firms that practice conservative accounting and are run by overconfident CEOs exhibit better performance, as measured by return on assets and Tobin's Q, especially following acquisitions, and lower crash risk. As expected, the joint positive effect of CEO overconfidence and accounting conservatism on firm performance is stronger in high-uncertainty environments and in firms facing less stringent financing constraints. The study has implications for the ongoing debate on encouraging entrepreneurial activity and are particularly relevant to corporate entrepreneurship. The counterintuitive result is that introducing—e.g., by changing regulatory requirements—a conservative bias encourages firms to become more entrepreneurial.

References.

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