CPA Speaker Series (ACCTG)

Alberta School of Business
Department of Accounting and Business Analytic

Presents:

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Topic:

CEO Overconfidence, Moral Hazard, and Investment

Friday, October 16, 2020
10:00am – 11:30am
Please join Zoom to access the seminar remotely
Meeting ID: 948 0595 5066
Password: 838650

ABSTRACT

Using an agency theory framework, we examine the effect of managerial overconfidence on the interaction between planning and control problems. We consider a typical setting in which a manager makes an investment decision involving project selection and a production decision to implement the chosen project. Thus, adverse selection and moral hazard problems affect different facets of management decision making, which allows us to examine how overconfidence affects the *interactions* between adverse selection and moral hazard. We show that overall welfare implications depend on the kind of overconfidence: productivity-related or state-related. When the agent overestimates the productivity of his effort, the principal can actually exploit the overconfidence and induce him to provide more effort at lower cost. However, overconfidence can either exacerbate an existing overinvestment problem or it can mitigate an existing underinvestment problem. We show that productivity-related over confidence unequivocally improves the principal's welfare. On the contrary, state-related overconfidence aggravates the effort incentive problem but can ameliorate the underinvestment problem. Overall, state-related overconfidence decreases investor welfare, consistent with the negative connotation we often ascribe to overconfidence.