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Investigating The Effect of Board of Director Characteristics on Overconfidence of Executive Managers: Evidence from Tehran Stock Exchange

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ABSTRACT

Overconfidence of managers can be defined baseless belief about cognitive abilities, judgments and intuitive reasoning that board of director characteristics can influence it. The main purpose of this research is to examine the effect of board of director characteristics on overconfidence of executive managers. For example, a sample including 121 companies listed in Tehran Stock Exchange during 2011 to 2014 were studied. To measure overconfidence of executive managers, two scales of "investment surplus" and "estimate of earnings per share" have been used and research hypotheses have been tested using logistic regression model. In general, the results of this study showed that there is a significant negative relationship between board of director independence and overconfidence of executive managers, and there is a significant positive relationship between Managing Director duality and overconfidence of executive managers, but there wasn't found a significant relationship between board of director size and overconfidence of executive directors.

JEL Classification: M10; M12.

Keywords: Overconfidence; Board of Director Characteristics; Duality of Managing; Size.

1. INTRODUCTION

People exaggerate about abilities such as their predictive power and information perception and their knowledge, in other words, they trust to their abilities and knowledge too much. It can be said that most people imagine themselves more intelligent than what they really are, and they believe that they have better information (Seif Elahi et al., 2015). The concept of "overconfidence" has been considered as a psychological concept in the past, and in 1986, it was introduced by Richard Hall in his article titled "Pride hypothesis in Economic Domain" (Johansson & Olvebrink, 2013). Overconfidence of managers can be expressed through deviation in the level of company's decision-makings, such as risk management and financing. There are two approaches in financial literature, in the first approach; it is assumed that managers are entirely rational, although board of director of directors is influenced by their emotional behaviors. But the second approach, which is a new approach, states that the logical capability of corporate governance mechanisms is influenced by irrational managers (Baccar et al., 2013). Managers with overconfidence are optimistic to profits and future cash flows of their business unit and have a positive outlook from risk and future returns of company (Sepasi & Asadi Wasfi, 2016). They estimate the possibility and impact of desirable events on the company's cash flows more and possibility and impact of negative events less (Heaton, 2002). Past research shows that the overconfidence of managers can be effective on policies of the company, such as merger and acquisition (Ferris, et al., 2013), dividend policy (Deshemukh, Goel and Howe, 2013), investment (Malmendier and Tate, 2005), and financing (Malmendier and Tate, 2011; 2008).

One of the factors influencing the overconfidence of executive managers is board of director characteristics. In Corporate Governance Literature, we face with emergence of a new task of internal corporate governance mechanisms (Behavioral corporate governance). Behavioral corporate governance is a potential solution in controlling the psychological characteristics of management. Parades (2005) states that the new role of corporate governance is to control the behavioral factors of management such as overconfidence or optimism, however, there is no wide theoretical literature on the potential impact of board of director characteristics on the personality traits of management (Baccar et al., 2013). The behavioral theory of corporate governance has not confirmed the hypotheses caused by individuals' rational behavior. Also, this theory states that the ability of human and organizations reduces in achieving efficient information, because their selection is often influenced by rational bias.

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Among the bias mentioned in most of the literature is overconfidence or selfishness of Managing Director, that this issue causes executive managers feel that they are superior to others and, therefore they consult less with others in making big decision. Because most executives to protect popularity tend to attribute their mistakes to bad luck or external events that are not in controlling them (Schwizer et al., 2014) Behavioral corporate governance focuses on analyzing the informal structure (irregular), which includes the morale through the implementation of the formal instruction. In behavioral research in the field of corporate governance, the outcome of executive managers and non- executive managers' behavior has investigated the relationship between key actors in systems of corporate governance and decision-making process (Huse, 2007). Therefore, the purpose of this study is to examine the effect of board of director characteristics on overconfidence of executive managers.

2. LITERATURE REVIEW

According to the report of European Commission (2010), the beginning of the financial crisis in 2007 has been board of director inability in identifying and controlling risk, especially in financial institutions. Among the weak control mechanisms (internal governance) observed identified by the Commission is difficulty of recognizing the board of director independence due to reduce confidence and technical experience as a result of the managing director's power. But while all efforts are to raise corporate governance standards, often board of director of director does its duty (decision-making) as ineffective (Schwizer et al., 2014). Board of director is one of the control mechanisms to manage the company and an important part of the company's structure. They are the link between people who are the source of capital (shareholders) and those who make value (management) from capital obtained. In fact, board of director is the interconnection between the strong group that manages the company and the relatively weak group who are willing to run the company. The main role of board of director is the supervision on executive management by shareholders (Baccar et al., 2013).

In the financial literature, it is assumed that board of director reduces the presence of representation problems. It also improves the decision-making strategy. In most studies on board of director, the focus is on reducing the problem of representation and the selection role of the managing director, but there is little evidence about the role of board of director in improving the decision-making strategy (Kolasinski and Li, 2011). According to Kolasinski and Li (2011), independent board of director helps managers to avoid obvious mistakes. They affect the personality traits of managing director (confidence). Overconfidence of managing director significantly reduces the value of shareholders' wealth by making poor decisions. But this confidence is not the opposite of the problem of representation. According to Ghaemi and Eskandarli (2013), executives who fail usually estimate more cash flow in the profit process, and this causes a decrease in the value of wealth of shareholders. Based on the modern theory of attractive stocks, the reason for this failure is irrational.

Board of director of company is a guiding entity that undertakes the role of supervising executive directors in order to protect the ownership interests of shareholders. It is indicated that the success of company is in desirable group. Recommendations have been raised to create a balance of power among board of director members in order to prevent unconditional control of decision-making process of some of the members of board of director in company. (Sadighi, 2013). According to Heaton (2002), it is not required to all members of board of director to be independent. They also state that independent directors are involved in the preparation of perfect financial statements. The independence of board of director can affect the overconfidence of executive managers. When board of director is controlled by independent directors, this issue reduces the ability of the unexpected behavioral features of managing director. If board of director has sufficient independence and expertise, he does more effective effort, according to Malminder and Tate (2008), managers who have overconfidence or they are optimistic may not behave wisely. But by the strong board of director, this behavior can be moderated.

Duality of managing director is said to a mode that managing director is the chairman of the board of director of directors. This position causes that managing director controls the information available to other members with more authority and as a result, this issue may prevent effective monitoring of managing director (Gerd et al., 2015). Representation theory points out that the contradiction between the duties of managing director reduces the supervisory role of managing director in relation to executive managers, which can have a negative effect on the company's performance. On the other hand, he is also the advocate of contradiction of managing director 's duties, and he claims that the contradiction can increase the performance of company, when it allows to executive managers to participate more through their use as chairman of the board of director of directors. When the duality of managing director occurs, there will be a lack in separation between decision-making of management and decision-making control. The results of some studies show that duality of managing director can have a positive effect on decision making and performance.

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Baccar et al., (2013) tested the duality of managing director on management optimism, and stated that duality of managing director and duty of chairman of board of director of directors can reduce the ability of optimism in management.

In the financial literature, a lot of research has been done on the effect of board of director size on corporate performance. Some of these studies showed that smaller board of director has more efficient and can play supervisory role better. But in contrast, larger board of director has a lot of problems, such as wasting time and high costs of appointment, so they cannot be a good observer. Lipton and Lorsch (1992) stated that a board of director with 8 or 9 members is more efficient. Also, another group of studies investigated the role of board of director size on decision-making. Large board of directors are more conservative to individual decision-makings and their decisions are less risky (Baccar et al., 2013). Parades (2005) discusses about the new role of corporate governance and controlling personality characteristics of management such as overconfidence or optimism. In this way, he assumes that the new mission of board of director will be effective as much as the previous mission (conflict of interest control). Schrand, and Zechman (2012) showed that a company with board of director members between 4 and 12 will reduce the effect of overconfidence or Managing Director optimism on decision making. It also states that a large board of director may reduce the quality of control to management, and not to be succeeding in reducing the optimism of executive managers.

Goel, and Thakor (2008) in their article entitled "Overconfidence, managing director Selection and Corporate Governance" showed that board of director probably does not work with managers who are over-confident. So they choose managers that their degree of overconfidence is appropriate. Kolasinsky and Lee (2011) studied the impact of strong board of director and business experience of management on Managing Director decision making. The results of this study indicate that the independence and power of board of director help to managers avoids false decisions with overconfidence. Baccar et al., (2013) examined the relationship between overconfidence, management's optimism, and board of director characteristics of companies. Their research results indicated that if the board of director size is small, the management's overconfidence will decrease. Also, the results of their research indicate that there is a negative relationship between the independence of board of director, the lack of duality in the managing director 's duties, the level of optimism and overconfidence of managers. Johansson and Elobrink (2013) examined the effective external factors on managing director overconfidence. The results indicate that external managers have a great influence on reducing the managing director overconfidence. In addition, they found that there is a significant relationship between overconfidence and manager's reward.

Li and Lang (2014), in a study entitled "Overconfidence of Senior Managers, Ultimate Controller and Company Value", stated that overconfidence of senior managers has a significant negative effect on the value of company, and this effect increases when the company is controlled by the government. They also showed that proper confidence of senior managers has a significant positive effect on the value of company, but the type of controller does not affect this relationship. Han et al., (2015) examined the effect of managing director overconfidence on the risk and performance of company. The results of this study showed that managing director overconfidence has a negative relationship with risk. Additionally, they found that there is a positive relationship between managing director overconfidence and company's performance. This result indicates that overconfidence can increase the interests of shareholders through increasing return of stocks, profitability, and risk reduction. Schaser, Carta and Svanna (2014), in their article, examined the relationship between the quality of board of director independence and managing director overconfidence. They studied 345 Italian companies during 2006 to 2011. They stated that companies with high economic performance have more quality of independent board of director. In addition, they found that the quality of independence of board of director leads to an increase in the value of company and a reduction in managing director overconfidence in the amount of investment and risk assessment of company.

Despite the studies conducted in other countries, no similar research has been conducted in Iran. Mashayekh and Behzadpour (2014) investigated the effect of managers' overconfidence on dividend policy. The results of this research showed that there is a negative and significant relationship between managers' overconfidence and corporate profit dividend, so that overconfident managers have a less profit dividend. Also, studies showed that by increasing operating cash flows, the overconfident manager estimates more future operational cash flows. Arabsalehi et al., (2014), in a research, examined the effect of overconfidence of senior managers on the sensitivity of cash flow investment. For this purpose, they tested a sample of 103 companies listed in the Tehran Stock Exchange during 2006 and 2010. The results of their study showed that overconfidence of senior managers has increased the sensitivity of investment - cash flows. Chavoshi et al., (2015), in their article, investigated the relationship between overconfidence of managers and the choice of financing policies. The results of their research indicate lack of correlation between overconfidence and financial decisions.

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In addition, the relationship between growth opportunities, profitability, company size and the distress risk with financial decisions is significant.

3. METHODOLOGY

The companies' managing director has more important and stronger position than the non-executive managers in the board of director of directors. However, past research has not confirmed the theory that managing director can play supervisory role better, or managing director has a more effective role in improving company performance. For example, Faleye (2011) showed that shareholders endure significant costs in cases that managing director is a member of the board of director of directors. Low and Stulz (2010) suggest that one of the ways that can prevent from enduring these costs by shareholders is that companies, among the famous and with quality managing director in the market appointed one as external managing director. The external managing director can be different in terms of personality traits, such as confidence. In particular, all managing directors tend to be more optimism and confident (Gu and Liu, 2013). According to Schrand and Zechman (2012), overconfidence most likely is related to profit management and financial fraud. In addition, the results of the research indicate that overconfidence of managing director in using new methods in risk projects is considered as a good feature. Therefore, according to the mentioned concepts in literature and hypotheses that researchers have considered in relation to the research subject and the results obtained, we raise the following hypotheses.

H1: there is a significant relationship between the board of director independence and overconfidence of executive managers.

H2: There is a significant relationship between managing director duality and overconfidence of executive managers.

H3: There is a significant relationship between board of director size and overconfidence of executive managers.

The statistical population of this research is limited to companies listed in Tehran Stock Exchange. The period of this research is from 2011 to 2014 for 4 years. Selecting sample from this population is done by considering the following criteria:

1- The data needed to calculate the variables to be available.

2- The end of the fiscal year of companies to be the end of March and not to be have change of fiscal year during the study period.

3. The shares of companies to be traded during each of the years of research period.

4- Not to be from active companies in insurance, banking and finance industries.
By considering these criteria, 121 companies were selected as sample.

In many studies, the dependent variable is not continuous and may have only two results. For example, accept only one of two values of one or zero that value one means occurring event and value zero means lack of occurring it (or vice versa). For these cases, the logistic regression model is used. The logistic regression model is similar to normal regression with the difference that the estimation method of coefficients is not the same. In the logistic regression model, the probability of an event occurring is maximizing, instead of minimizing the squat errors (which is done in the normal regression). The most important feature of the logistic regression model is that there is no need to establish the assumptions of normality and consistency of covariance matrices. In this research, a multivariate logistic regression model has been used. In the logistic regression model, the overall significance of the model is done using the Chi square statistics. The Chi square statistic tests the null hypothesis based on the coefficients of the independent variables equal to zero. If the significant value of the test statistic is less than 0.50, null hypothesis on zeroing all the coefficients of independent variables are not accepted, and at least one of the coefficients is significant. Therefore, the logistic regression model is significant totally.

To test the research hypotheses, based on Baccar et al., (2013) and Johansson and Elobrink (2013), a multi-variable regression model with the following combination data is used.

Model (1):

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$OVER_{jt} = \alpha_0 + \alpha_1 BSIZS_{jt} + \alpha_2 DUALITY_{jt} + \alpha_3 BIND_{jt} + \alpha_4 AGE_{jt} + \alpha_5 SIZE_{jt} + \alpha_6 MTB_{jt} + \alpha_7 CF_{jt} + \varepsilon_{jt}$

The dependent variable of this research is overconfidence of executive managers (OVER). For this purpose, two criteria have been used to measure overconfidence of executive manager.

OVER EPS: As Mashayekh and Behzadpour's research (2014), if managers predict the predicted profits more than real profit, this indicates that management has overconfidence, then the number 1 and otherwise zero.

OVER INV: Given the fact that the company's investment decisions contain information about the managerial overconfidence.

In this study, according to research by Ahmad and Duelman (2013), to measure the managerial overconfidence, surplus investment criterion is used. For this purpose, the regression model 2 is estimated as cross-sectional and then calculated in each remaining year. If the remaining of model 2 for a company is larger than zero, it means that the company has been overestimated. Therefore, if the remaining of the model 2 is larger than zero, it is equal to one; otherwise zero will be considered (Arabsalehi et al., 2015).

Model (2): $GROW*ASSET_{jt} = \alpha_0 + \alpha_1 GROW*SALE_{jt} + \varepsilon_{jt}$

GROW * ASSET: Growth of assets of company that is calculated from the difference of changes in assets compared to the company's previous year.

GROW * ASSET: It is growth of sales of company that is calculated from the difference of changes of sales compared to the company's previous year.

Independent Research Variables are:

Board of director Independence (BIND): The number of non-executive members (independent) in the composition of the board of director, divided by the total number of members of board of director of directors

Managing director duality (DUALITY): It refers to a mode that Managing Director simultaneously to be the chairman of the company's board of director of directors. Therefore, this index is a virtual variable. If Managing Director is simultaneously the chairman of the board of director, the number 1, otherwise zero.

Board of director size (BSIZS): It is equal to the number of board of director members.

Control Variables of Research are:

Size of the company (SIZE): it is equal to the natural logarithm of the market value of company.

Age of Company (AGE): It is equal to the number of years of activity of company.

Market to Book Ratio (MTB): It is equal to the division of the market value of equity to the book value of equity.

Cash Flow (CF): It is equal to operating cash flows divided by total asset of company.

4. RESULTS AND DISCUSSION

In the descriptive statistics section, data analysis is done using central indicators such as mean and medium and dispersion indices such as standard deviation. According to Table 1, managers of most of companies have downward bias in predicting profit of each share in a simpler statement, managers not have overconfidence. Also, the average investment surplus is equal to 0.593, which indicates that managers of most companies have overconfidence in relation to investment. Based on descriptive statistics, the average Managing Director 's duality (0.388) indicates that in a small number of sample companies, the position of Managing Director and chairman of the board of director of directors is in responsibility of one person. Also, 0.630% of the members of the companies' board of director of directors are non-executive members. In addition, given the median and average proximity of most variables, it indicates that research variables have a good distribution. Also, given that the standard deviation of none of them is zero, they can be used in the regression model.

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Table 1. Descriptive Statistics

Variable	Symbol	Average	Medium	Maximum	Minimum	SD
Criterion of profit per share	OVER EPS	0.328	0	1	0	0.470
Investment criterion	OVER INV	0.593	1	1	0	0.492
Board of director independence	BIND	0.630	0.6	1	0	0.197
Managing Director duality	DUALITY	0.388	0	1	0	0.488
Board of director size	BSIZE	5.159	5	7	4	0.443
Company's size	SIZE	13.419	13.346	18.863	10.133	1.547
Company's age	AGE	36.624	37	60	12	11.253
Market to book ratio	MTB	2.342	2.051	51.624	-53.218	4.445
Cash flow	CF	0.129	0.111	0.642	-0.429	0.138

A basic issue in logistic regression is the issue of linearity, which means the correlation of each of the independent variables to each other. Table 2 shows the correlation of independent variables according to the company's data. In this Table, (*) represents significance of model at the 90% confidence level, (**) represents significance of model at 95% confidence level and (***) represents significance of model in 99% confidence level. The correlation coefficients reflected in this Table represent a relatively strong correlation between the Board of director independence (BIND) with Managing Director duality and the market-to-book ratio (MTB). There is also a strong correlation between Managing Director duality and board of director size (BSIZE). On the other hand, there is a significant correlation between the board of director size (BSIZE) and company's age (AGE).

Table 2. Correlation between Variables

Symbol	Results	BIND	DUALITY	BSIZE	SIZE	AGE	MTB	CF
BIND	Correlation coefficient Sig	1	0.256 0.036**	0.303 0.152	0.623 0.124	-0.107 0.278	0.044 0.027**	0.133 0.290
DUALITY	Correlation coefficient Sig		1	0.018 0.006***	-0.062 0.115	0.023 0.632	0.012 0.063*	0.056 0.216
BSIZE	Correlation coefficient Sig			1	0.003 0.236	0.021 0.087*	0.059 0.495	0.021 0.352
SIZE	Correlation coefficient Sig				1	0.108 0.214	-0.196 0.057*	0.043 0.436
AGE	Correlation coefficient Sig					1	0.009 0.826	0.056 0.752
MTB	Correlation coefficient Sig						1	0.086 0.0166
CF	Correlation coefficient Sig							1

Table 3 shows the test results of research hypothesis using the first criterion of overconfidence of managers (OVER EPS). Given that the calculated P-Value for the LR model is less than the 5% error rate, it can be concluded that the whole model is significant and has high validity. Also, Chi-Square of Hosmer-Lemeshow test is 6.325 and larger than 0.05, so the estimated model has a good fit.

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The estimated coefficient for board of director independence (BIND) variable and Managing Director duality variable (DUALITY) is calculated -2.054 and 0.491, respectively, and the P-value calculated for them is less than the error level of 5%. Therefore, with 95% confidence, it can be argued that the board of director independence and Managing Director duality affect the overconfidence of managers. The negative coefficient of the board of director independence variable indicates that the more the number of non-executive members of the board of director is more, managers will have less overconfidence, or, in other words, the managers will behave more rational. Also, the positive coefficient of Managing Director duality indicates that, when a person is simultaneously Managing Director and the chairman of the board of director, the overconfidence of managers increases.

Table 3. Results of Estimating the Research Model

dependent variable of model: overconfidence of executive managers caused by predicting profit per share (OVER EPS)				
Explanatory variable	Coefficient	Z static	p-value	Significant level
C	4.870	2.995	0.0027	99%
BIND	-2.054	-3.737	0.0002	99%
BSIZE	0.094	0.411	0.681	Non- significant
DUALITY	0.491	2.214	0.03	99%
SIZE	-0.423	-5.114	0.0000	99%
MTB	0.061	2631	0.0085	99%
CF	-2.530	-3.023	0.0025	99%
AGE	0.021	2.089	0.036	99%
LR static	61.588	Hosmer test	6.325	
Probability of LR static	0.00000	Probability of Hosmer	0.561	
R^2 Mac Faden	0.322			

In addition, the estimated coefficient for the board of director size variable (BSIZE) is 0.094 and the calculated P-value for them is more than the 5% error level. Therefore, there is no significant relationship between the size of the board of director and overconfidence of managers. The value of coefficient of determination of Mac Faden is also equal to 0.322, which indicates that the set of explanatory variables justifies about 32% of the dependent variable.

Table 4. Results of Estimating the Research Model

dependent variable of model: overconfidence of executive managers caused by investment surplus (OVER INV)				
Explanatory variable	Coefficient	Z static	p-value	Significant level
C	-0.926	-0.637	0.5222	99%
BIND	-0.933	-1.824	0.048	95%
BSIZE	-0.209	-0.987	0.323	Non- significant
DUALITY	0.207	1.003	0.315	Non- significant
SIZE	0.243	3.592	0.0003	99%
MTB	0.050	2.209	0.0271	99%
CF	-3.020	-3.887	0.0001	99%
AGE	-0.018	-0.213	0.831	Non- significant
LR static	35.937	Hosmer test	5.856	
Probability of LR static	0.00007	Probability of Hosmer	0.634	
R^2 Mac Faden	0.248			

Table 4 shows the results of the research hypothesis test using the second criterion of overconfidence of executive managers (OVER INV). According to Fig. 4, the probability of LR statistics is less than the 5% error level, which indicates that this model is significant in the confidence level and is has high validity. The coefficient for the board of director independence variable (BIND) is calculated -0.933. The possibility of estimated coefficient is calculated smaller than the 5% error level. Therefore, the coefficient calculated is significant in confidence level of 95%. In other words, board of director independence has a negative effect on

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overconfidence of executive managers. Also, there is no significant relationship between the Managing Director duality and size of the board of director with overconfidence of executive managers. In addition, there is a significant positive relationship between size of company, market to book ratio, and operating cash flow with overconfidence of executive managers. But there is not any significant relationship between company's age and overconfidence of executive managers. In order to investigate the fit of the estimated model, the Hosmer-Lemeshow test is used and considering the possibility of the Hosmer-Lemeshow test is more than 0.05, therefore, the estimated model has a good fit.

5. CONCLUSION

Irrationality of management can have a significant impact on corporate policies. Managers with overconfidence estimate the likelihood and impact of desired events on the company's cash flows more than reality, and evaluate the likelihood and impact of negative events less than reality. As stated, the purpose of this research is the impact of board of director's mechanisms on overconfidence of executive managers. For this purpose, a sample of 121 companies listed in Tehran Stock Exchange was investigated in 2011 to 2014. Also, two indicators of predicting profit per share and investment surplus were used as overconfidence measures of executive managers. The results of the research hypothesis test based on the use of index of predicting profit per share show that there is a significant negative relationship between the independence of the board of director and overconfidence of executive managers. In other words, if the number of non-executive members is higher in the board of director, managers have less overconfidence. Also, surveys showed that there is a significant positive correlation between managing director duality and overconfidence of executive managers. However, no significant relationship was found between board of director size and overconfidence of executive managers.

In addition, the research findings based on the criterion of investment surplus indicate a negative relationship between the independence of the board of director and overconfidence of executive managers. The result of this research about the relationship between the independence of the board of director and overconfidence of executive managers is consistent with the results of the research by Baccar et al., (2013) and Johansson and Elobrink (2013), and Schizier, Carte and Suanna (2014) but it is inconsistent with result of the research by Baccar et al., (2013) in relation with managing director duality and board of director size with overconfidence of executive managers.

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