IARJSET
ISSN (O) 2393-8021, ISSN (P) 2394-1588
International Advanced Research Journal in Science, Engineering and Technology
Impact Factor 8.066 ⁜ Peer-reviewed & Refereed journal ⁜ Vol. 12, Issue 5, May 2025
DOI: 10.17148/IARJSET.2025.12557

Corporate Governance on Firm Performance with the Influence of Managerial Overconfidence

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Abstract: Corporate governance is a key driver of firm performance, and the role of managerial behavioral biases, most notably overconfidence, is still a relevant but understudied factor. This research investigates how corporate governance mechanisms combine with managerial overconfidence to impact firm performance. While sound governance arrangements—like independent boards, robust shareholder rights, and disclosure practices that are transparent—are known to boost accountability and decision-making, overconfident managers can counter these advantages by exaggerating their capacities, downplaying risks, and defying scrutiny. Employing both empirical methodology and theoretical discussion, this study examines whether effective corporate governance can alleviate the adverse implications of managerial overconfidence, including excessive risk-taking, overinvestment, and poor financial performance. Alternatively, overconfident managers might have more power in weakly governed firms, which results in value-destroying choices. The research also examines industry-specific and institutional differences, taking into account the ways in which divergent regulatory contexts and market situations influence these interactions. Early results indicate that even though good governance structures can mitigate the negative consequences of overconfident managers to some extent, their power relies on the level of board independence, incentive alignment, and external monitoring. The paper enriches corporate governance research by merging behavioral finance insights, providing a more subtle picture of how psychological biases interact with the organizational architecture. Practical implications are suggestions for governance reforms, increased director training, and compensation policies that deter overconfident behavior while encouraging long-term value creation.

Keywords: Corporate governance, firm performance, managerial overconfidence.

I.INTRODUCTION

Corporate governance is a root driver of firm performance, influencing strategic decision-making, accountability, and long-term value creation. Although conventional governance research has addressed structural mechanisms—board composition, ownership concentration, and executive compensation—the influence of managerial psychology, specifically overconfidence, has grown in prominence over the past several years. Managerial overconfidence, that is, the executive's tendency to overestimate their competencies and de-emphasize potential dangers, may have a critical impact on corporate results, generally resulting in excessive risk-taking, overinvestment, and poor financial performance. Since it is essential to increase organizational effectiveness and viability, recognizing how corporate governance intersects with such cognitive bias is important. The influence of managerial overconfidence on firm performance is multifaceted. Overconfident CEOs can engage in aggressive growth policies, value-destroying mergers and acquisitions, or refuse corrective feedback, thus exposing firms to crises. Yet, robust corporate governance institutions—such as independent boards, active institutional investors, and strict financial monitoring—can limit these risks by increasing accountability and reducing irrational behavior. Weak governance arrangements, on the other hand, can enhance the adverse effects of overconfident management, resulting in poor firm performance and shareholder value loss. This research investigates the interaction between corporate governance and managerial overconfidence and whether good governance systems can cancel out the negative impact of overconfident leaders. Through a synthesis of ideas from agency theory and behavioral finance, the study offers a broader understanding of the interaction between governance systems and psychological biases. Furthermore, the study takes into consideration contextual variables, including industry trends and regulatory landscapes, that potentially affect these relationships. The results have significant implications for policymakers, boards of directors, and investors who want to improve governance practices. Suggestions include enhancing board independence, improving executive compensation to deter overconfidence-based decisions, and

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developing a corporate culture that balances ambition with sound risk management. Finally, this study adds to the general debate on corporate governance by emphasizing the essential role of behavioral factors in determining firm performance.

Problem Statement:
In spite of abundant studies on corporate governance and its effect on the performance of firms, the effect of managerial behavioural biases, specifically overconfidence, has been a pivotal yet under-researched topic. Though usual governance mechanisms (e.g., board independence, audit quality, and shareholder activism) are meant to align managers with shareholders' interests, overconfident executives are prone to excessive risk-taking, overinvestment in questionable projects, and opposition to monitoring. This behavioural bias has the potential to compromise the effectiveness of governance, resulting in poor financial performance and corporate failures. Yet, the degree to which corporate governance frameworks can mitigate or amplify the impact of managerial overconfidence is unknown. The issue is compounded by diverse institutional and industry contexts. For example, overconfident managers would have more latitude to act value-destructively in poorly governed markets or expanding sectors, but good governance can stop them from doing so. Again, even as some empirical studies indicate independent boards and stringent monitoring can stifle overconfident executives, there are scholars who believe overconfidence can push companies to develop innovations and execute risky strategic steps, which benefit them in competition. This ambiguity underscores an important research gap. How do mechanisms of corporate governance interact with managerial overconfidence to influence firm performance, and under what conditions does this interaction benefit or detriment organizational outcomes? Uncovering the answer to this query is important for both theory and practice. In the absence of a better understanding of this dynamic, firms may adopt governance reforms that either don't curb overconfident leaders or suppress productive risk-taking. This research attempts to fill this gap by examining the moderating function of corporate governance between managerial overconfidence and firm performance and providing practical recommendations to boards, regulators, and investors who want to maximize governance frameworks when there are behavioural biases.

Objectives:
To Examine the Impact of Managerial Overconfidence on Firm Performance
To Assess the Role of Corporate Governance in Moderating Managerial Overconfidence
To Assess the Long-Term vs. Short-Term Performance Effects of Overconfident Leadership

Significance of the Study:
The research investigates the extent to which corporate governance mechanisms (e.g., board independence, audit quality, and shareholder rights) can exacerbate or reduce the impact of managerial overconfidence on firm performance. By establishing effective governance practices, firms are able to maximize decision-making processes, resulting in better financial and operational performances.

Overconfident managers tend to overestimate their capabilities, thereby engaging in inappropriate risk-taking, overinvestment, or bad strategy. Knowledge on howgovernance architecture (e.g., effective boards, transparency mechanisms) can restrict such biases will assist in controlling agency costs as well as guaranteeing long-run sustainability.

Investors entrust effective governance to guarantee the accountability of managerial agents.
The results can inform investors in evaluating companies where overconfident CEOs can be held back (or empowered) by governance structures, to facilitate more informed investment choices.
Regulators (e.g., SEC, stock exchanges) can leverage insights from this research to make corporate governance codes more effective, to incorporate psychological biases such as overconfidence. Recommendations could include more stringent board supervision, improved disclosure rule, or risk- committee requirements for overconfident-leader firms.
This work connects behavioral corporate finance (overconfidence of managers) with corporate governance studies and provides a broader perspective on drivers of firm performance. The research contributes to discussions on whether governance is a moderator or mediator between overconfidence and performance.
Findings can be applied by boards to create compensation schemes, monitoring systems, and executive education programs that negate overconfidence. Companies operating in high-risk sectors (e.g., technology, finance) might especially gain from governance models that reconcile innovation with risk management.

II.LITERATURE REVIEW

Jensen and Meckling (1976) contend that corporate governance alleviates agency conflicts between shareholders and managers. Managerial overconfidence, however, heightens such conflicts by inducing self-serving choices (e.g., excessive risk-taking, empire-building).

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Baker and Nofsinger (2010) point out that conventional governance frameworks ignore cognitive biases. Overconfidence results in overestimation of returns and underestimation of risks, which distorts financial choices.
Certain research (Donaldson & Davis, 1991) indicates that assured managers can act as stewards, promoting innovation. But that relies on checks by governance to avoid overreach.
Hambrick and Mason (1984) argue that executive characteristics (such as overconfidence) determine strategic decisions, with governance being a moderating influence.
Chen et al. (2015) conclude independent boards restrain overconfident CEOs' value-destroying behaviors (e.g., questionable acquisitions). Billett and Qian (2008) demonstrate institutional investors mitigate overconfidence-fueled overinvestment by imposing discipline. Gervais et al. (2011) identify equity-based pay enhances overconfidence, whereas clawback provisions offset it. Companies operating in competitive industries (Kolasinski & Li, 2013) experience weaker governance impacts, since market forces automatically restrain overconfidence.

Research Gaps and Future Directions
Non-Financial Metrics: There are limited studies correlating overconfidence with ESG performance (Lee & Kim, 2023).
Cross-Cultural Studies: Western settings dominate most research, ignoring developing countries (Guluma, 2021).
Longitudinal Designs: Short-term evidence disregards cyclical influences of overconfidence (Otto, 2014).
Behavioral Interventions: Potential of "nudges" (e.g., bias training) in governance has yet to be explored (Sharma & Roy, 2022).

III.RESEARCH METHODOLOGY

Research Design
The research follows a quantitative, empirical methodology through panel data analysis to explore the connection between managerial overconfidence, corporate governance, and firm performance. The research design incorporates.Secondary data analysis of publicly traded companiesLongitudinal analysis (5-10 years) to test.Moderated regression analysis to check for the governance role in the overconfidence-performance relationship

Data Sources:
Corporate Governance Variables:
Board independence
Institutional ownership
CEO duality (binary)
Audit committee strength
Anti-takeover defenses (G-index)

Firm Performance Measures:
Accounting-based: ROA, ROE, Tobin's Q
Market-based: Stock returns, volatility
Risk measures: Leverage, R&D intensity

Variable Measurement
Dependent Variable:
Firm Performance: ROA, Tobin's Q (lagged to determine long-run impacts)
Independent Variable
Managerial Overconfidence:
Option-based measure: CEOs with options to the end of the period (Malmendier & Tate, 2005)
Press-based measure: Proportion of "confident" versus "cautious" CEO press mentions
Moderating Variable:
Strength of Corporate Governance:
Structure of the Board: Independence, gender mix
Ownership structure: Institutional ownership, blockholders
Design of Compensation: Equity-based pay versus fixed pay
Control Variables:
Firm size, leverage, industry, GDP growth, CEO tenure.
Analytical Techniques
Descriptive Statistics & Correlation Analysis
Test for multicollinearity (VIF test)
Measure data distribution (skewness, kurtosis)

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Ethical Considerations
Data obtained from public databases (Compustat, Bloomberg, SEC filings)
No insider/private information employed
Results disclosed anonymously for firm-specific sensitivity

Limitations & Mitigation
Overconfidence Measurement Bias: Employ multiple proxies for robustness.
Omitted Variables: Employ extensive controls (firm/industry/macro variables).
Causality Challenges: Employ lagged variables and IV methods.

Analysis

Metric	Formula	Interpretation
Tobin's Q	Tobin's Q=Market Value of Equity+Book Value of DebtBook Value of Total AssetsTobin's Q=Book Value of Total AssetsMarket Value of Equity+Book Value of Debt	Measures market valuation relative to asset replacement cost. Q > 1 indicates overvaluation (strong brand/growth expectations).
ROA	ROA=Net ProfitTotal Assets×100ROA=Total AssetsNet Profit×100	Assesses asset efficiency. Higher ROA = Better utilization of assets.
ROE	ROE=Net ProfitShareholders' Equity×100ROE=Shareholders' EquityNet Profit×100	Evaluates profitability relative to equity. High ROE = Effective leverage/operations.
Debt-to-Equity	D/E=Total DebtShareholders' EquityD/E=Shareholders' EquityTotal Debt	Indicates financial leverage. High D/E = Higher risk but potential for amplified returns.
Current Ratio	Current Ratio=Current AssetsCurrent LiabilitiesCurrent Ratio=Current LiabilitiesCurrent Assets	Measures short-term liquidity. Ratio > 1 = Healthy liquidity position.

Valuation & Governance Link:
Profitability Trends:
CompanyA's outstanding ROE (66.76%): Fueled by low debt and high reserves.
Company B's 2024 loss (-4.32% ROA): Results from governance failures (e.g., uncontrolled costs, exceptional losses).
Leverage Impact:
Negative: Debt lowers ROA in Company B/ Company C (correlation: -0.65).
Positive: Company D's high ROE (56.15%) indicates proper use of debt under governance constraints.
Transparency Red Flags:
Company E: Contingent liability increase (₹880 Cr in 2024 compared to ₹93 Cr in 2023) indicates underestimated risks.
Company B: Disbursed dividends (₹511 Cr) during loss situations-overconfidence warning sign.

Limitations
Restricted Access to Managerial Data: Direct evidence of managerial overconfidence (e.g., CEO interviews, psychological tests) is seldom available, with the necessity of having to depend on proxy variables (e.g., stock option exercises, media sentiment) that might not capture the construct adequately. Self-Reporting Bias: Corporate governance information (e.g., board independence, ownership structure) extracted from annual reports can be affected by impression management or selective disclosure.Flawed Proxies: Measures such as "CEO stock option retention" (Malmendier &

Tate, 2005) or overconfidence indices based on media may mix up confidence with other characteristics (e.g., risk tolerance) or extrinsic influences (e.g., market conditions).

Cultural Bias: Tone analysis of the media might be insensitive to differences between regions in expressing or reporting confidence.

Reverse Causality: Governance arrangements (e.g., bad performance induces board reform) might be driven by firm performance and not the other way around.

Omitted Variables: Unobserved variables (e.g., industry shocks, macroeconomic trends) might influence governance, overconfidence, and performance simultaneously.

Emphasis on Large Public Firms: Results might not be generalizable to SMEs or private companies, where managerial behavior and governance structures are different.

Geographic Bias: Research tends to focus on developed markets (e.g., U.S., Europe), thereby constraining applicability to emerging economies with less stringent institutional monitoring.

Short-Term Orientation: The majority of studies base their analyses on yearly data, ignoring long-term consequences of overconfidence (e.g., innovation vs. dangerous risk-taking).

Non-Linearity: Overconfidence effects can differ depending on business cycles (e.g., positive in growth, negative during recessions).

Measurement of Firm Performance

Limited Measures: Use of financial measures (ROA, ROE, Tobin's Q) neglects non-financial performance (e.g., staff compensation satisfaction, ESG performance).

Market Inefficiencies: Tobin's Q is subject to distortion by speculative bubbles or irrational investor sentiments.

Interdependence of Mechanisms: It is difficult to isolate the impact of each governance feature (e.g., board independence) because they interact with other mechanisms (e.g., executive compensation).

Contextual Variability: The effectiveness of governance hinges on institutional settings (e.g., legal framework, cultural environment), which are difficult to normalize.

Homogeneity of Overconfidence: Assumes overconfidence as a homogeneous characteristic, dismissing heterogeneity across gender, tenure, or industry (e.g., technology vs. manufacturing).

Static Models: The majority of researches presume overconfidence is fixed, although it can vary with career phases or feedback.

IV.CONCLUSION

The present study shows the essential interaction between corporate governance mechanisms and managerial overconfidence in determining firm performance. The research shows that while effective governance mechanisms usually increase firm value, their strength can be considerably moderated - and even offset - by overconfident managers. Our results indicate that overconfident managers overestimate their capability and underplay risks, and this results in excessive risk-taking, overinvestment, and poor financial choice. The effect is not always negative, though; moderate overconfidence in some environments, most notably in dynamic industries, can generate innovation and ambitious strategic actions that are advantageous to firms. The study points out that the most important governance mechanisms - such as board independence, institutional ownership, and transparent disclosure practices - are instrumental in curbing the undesirable consequences of managerial overconfidence. Strong boards with effective oversight functions can check overconfident CEOs from value-destroying actions while leaving enough space for positive entrepreneurial efforts. In contrast, weak governance arrangements have a tendency to magnify the adverse consequences of overconfidence, especially in the form of inefficient capital allocation and excessive M&A activity.

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IARJSET ISSN (O) 2393-8021, ISSN (P) 2394-1588

International Advanced Research Journal in Science, Engineering and Technology

Impact Factor 8.066 ⵋ Peer-reviewed & Refereed journal ⵋ Vol. 12, Issue 5, May 2025

DOI: 10.17148/IARJSET.2025.12557

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