CEO OVERCONFIDENCE, FOUNDER & RESTATEMENT OF FINANCIAL REPORTING

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ABSTRACT

This study has two research questions: 1) Does CEO overconfidence have a positive effect on restatement of financial reporting and 2) the existence of the founder in weakening the relationship between CEO overconfidence and restatement of financial reporting. The motivation of this research is the limited research on the relationship between CEO overconfidence and restatement of financial reporting, especially in countries where the majority are family companies. Generally, family companies will be controlled by the family itself, especially the company founder. Founders are considered to be more concerned with maintaining the company’s reputation in the future and have a high sense of ownership of the company so that they will avoid actions that can be detrimental to the company. So far, there is still no test that examines the role of the founder in weakening the relationship between CEO overconfidence and the restatement of financial reporting so that it is one of the motivations for conducting this research. CEO overconfidence has characteristics that are reflected in its leadership in the company. CEO overconfidence has the courage to take high risks, invest excessively without estimating returns and risks accurately, be innovative, like debt financing, reluctance to pay dividends and tend to manipulate earnings or other fraud actions on financial reporting. Therefore, a company led by a CEO overconfidence will have a high level of restatement of financial reporting. However, the relationship between CEO overconfidence and restatement of financial reporting will be weak if the CEO overconfidence is also a founder of the company. That is because the CEO founder will be more careful in maintaining the company's reputation. This study uses a sample of non-financial companies listed on the Indonesia Stock Exchange in 2013-2018. This study uses logistic regression analysis in answering the research hypothesis. The results of this study indicate that CEO overconfidence has a positive relationship with the restatement of financial reporting. However, the existence of the founder will weaken the positive relationship between CEO overconfidence and restatement of financial reporting. This study contributes to the development of literature related to founders, CEO overconfidence and restatement of financial reporting. In addition, this research is expected to provide an insight for auditors and investors in identifying the possibility of restatement of financial reporting.

Keywords: CEO overconfidence, founder, restatement of financial reporting

INTRODUCTION

This study examines the relationship of CEO overconfidence to restatement of financial reporting that is still rarely studied in public companies in Indonesia, which are majority owned by the family. Companies owned by the family are usually led by the CEO who is the founder of the company itself. The company led by the CEO founder has more value because the founder has a high sense of ownership of the company, trying to maintain the reputation and sustainability of the company in the future so that it tends not to do activities that harm the company (Chen et al., 2010; Fahlenbrach, 2009). Thus it is necessary to further investigate the existence of the CEO founder who is predicted to be able to mitigate the relationship between CEO overconfidence and restatement of financial reporting. CEO founders will be more careful in taking risky actions and try to minimize the risk of litigation in the future.

CEO is a company leader who plays a high role in making decisions related to company operations including corporate financial reporting. In the upper echelon theory, Hambrick & Mason (1984) states that the characteristics of the CEO will be identical to the company he or she leads. One of the characteristics of a CEO is overconfidence or high confidence, assumes that he or she is better than his or her average and is very optimistic about the future (Lee, 2016). CEO overconfidence has several unique characteristics that are reflected in his or her behavior towards the company, namely his or her preference for investing excessively (Malmendier & Tate, 2005, 2008), courage to take high risks (Hirshleifer, Low, & Teoh, 2012), unwillingness to pay dividends (Deshmukh et al., 2013), like external funding in the form of debt (Malmendier et al., 2011), mergers and acquisitions (Malmendier & Tate, 2008) and are innovative individuals (Hirshleifer et al., 2012). Thus, CEO characteristics such as overconfidence will have an impact on corporate financial reporting.

Research on the characteristics of CEO overconfidence toward restatement of financial reporting has been conducted by Koloub & Shooverzy (2015); Presley & Abbott (2013) which shows that CEO overconfidence is positively related to the restatement of corporate financial reporting. That is because CEO overconfidence has a tendency to cheat financial reporting (Hribar & Yang, 2016; Schrand & Zechman, 2012). Encouragement and motivation of CEO overconfidence cheating on financial reporting because CEO overconfidence seeks to achieve or even exceed certain targets to improve professional reputation and welfare. CEO overconfidence also thinks that he or she is better than the average, so he or she is not careful in estimating high returns and estimating low risks for a number of investments made in the company (Hribar & Yang, 2016; Presley & Abbott, 2013; Malmendier & Tate, 2005). Thus, companies led by CEO overconfidence will have a great tendency to conduct restatement of financial reporting.

However, this study predicts that the existence of CEO founders will be able to mitigate the positive relationship between CEO overconfidence and restatement of financial reporting. Company founders have a tendency to be more careful in maintaining the company’s reputation and long term sustainability because the founder has a high sense of ownership of the company which is a form of life achievement (Chen et al., 2010; Fahlenbrach, 2009). Thus the founder will try more to maximize the value of the company than the professional. However, other research conducted by Tang et al. (2016); Lee et al. (2017) have findings that show that founders are more likely to have the characteristics of overconfidence and courage to take high risks. For this reason, further
research is needed to examine the role of CEO founder on the relationship between CEO overconfidence and restatement of financial reporting.

This study took a sample of non-financial companies in Indonesia in the period 2013-2018. The sample selection of public companies in Indonesia is because the majority of companies in Indonesia are dominated by family parties. Family companies usually place the founder or family members of the founders in important positions in companies such as CEO or Boards of Directors or Commissioners. There are more than 20% of public companies in Indonesia led by CEO founder. The research period began in 2013 because in 2012, Indonesia adopted the convergence of IFRS (International Financial Reporting Standards) standards, especially for publicly traded companies, so as to reduce the bias of research results due to adjustments in the company's financial reporting with new standards, the research period began in 2013. Testing this study uses logistic regression analysis because it has a dependent variable in the form of a dummy variable that is 1 if the company performs a restatement of financial reporting and a value of 0 otherwise. The research proves that CEO overconfidence increases the tendency of companies to do restatement of financial reporting. Whereas the existence of CEO founder will weaken the positive relationship between CEO overconfidence and restatement of financial reporting.

The contribution of this research to the development of literature related to founder, CEO overconfidence, and restatement of financial reporting is still very rarely researched. Previous studies only tested the relationship between CEO overconfidence and restatement in financial reporting and have not confirmed the existence of CEO founders who can mitigate the relationship between CEO overconfidence and restatement of financial reporting. In addition, this study contributes to the measurement of CEO overconfidence carried out by combining several proxies that are tailored to the Indonesian environmental context so that a more comprehensive measurement will be found. The findings of this study are expected to be useful in decision making by auditors and investors in identifying potential financial reporting restatements.

This research consists of the following sections. The first part shows the background, objectives, contributions and research implications, while the second part discusses the literature review and the development of hypotheses related to the relationship of founder, CEO overconfidence and restatement of financial reporting. Section three displays the sample, data and research methods used. Part four of this study concerns the results of the study and discussion of the results. The final part of this study contains conclusions and limitations of the study.

LITERATURE REVIEW AND HYPOTHESES

Agency Theory

Agency conflict arises because each individual is motivated to prosper their respective interests and arises because of the condition of information asymmetry. Type one agency conflict is a conflict of interest between the principal (shareholders) and agent (management) while the agency conflict that arises in family companies is type two, namely between the controlling shareholder (family) and non-controlling. Controlling shareholders are more free to maximize their own profits because they have more control over the company. The agency problem type two also shows the manipulation of accounting earnings (Ali et al., 2007). Various forms of financial statement fraud will increase the existence of financial statement restatement in the period thereafter.

CEO Overconfidence

CEO overconfidence is one of the personal characteristics that considers itself better than others, has an overly optimistic attitude towards investments made and estimates low risk (Hirshleifer et al., 2012). CEO overconfidence also has a tendency to manipulate earnings and fraud on financial reporting (Alqatamin et al., 2017; Hribar & Yang, 2016; Kouab & Jarboui, 2016, 2017; Schrand & Zechman, 2012). However, CEO overconfidence has positive characteristics, namely individuals who are innovative, dare to take risks, make a lot of investments so as to increase the value of the company (Hirshleifer et al., 2012). Another characteristic of CEO overconfidence is its tendency to overinvest (Malmendier & Tate, 2005, 2006), likes funding in the form of debt, reluctance to pay dividends, courage to take risks.

Founder

Company founders are individuals who have an entrepreneurial spirit, dare to take risks and have a high sense of ownership of the company (Casson, 1999) so that it strives to maintain the reputation and avoid behaviors that harm the company (Fahlenbrach, 2009). In addition, CEO founders have a longer time in the company than professional CEOs who have shorter time (Ali et al., 2007). Other research conducted by Fahlenbrach (2009) shows that the CEO founder thinks that the company he or she founded is a life achievement so that he or she will try to maximize the value of the company. In addition, the research stated that CEO founders have more ability to manage companies, have influence and power to make decisions, have an entrepreneurial spirit, dare to take risks on an investment and think in the long term. Thus the CEO founder has high overconfidence characteristics compared to professional CEOs (Lee, 2016).

Restatement of Financial Reporting

Financial reporting restatement is restatement of the company's previous financial reporting due to material misstatement. The causes of material misstatement can be caused by: 1) misstatements due to errors of inherent risk in the financial reporting presentation process; 2) misstatements that are not detected by the company's internal audit; 3) misstatements that are not detected by external audits; 4) material misstatement that requires restatement (Eilifsen & Messier, 2000). In addition, restatement of financial reporting can also occur due to changes in applicable accounting standards or the cessation of business operations. Restatement of financial reporting is often an indication of fraud in corporate financial reporting.
The Relationship between CEO Overconfidence and Restatement of Financial Reporting

In a previous study conducted by Presley & Abbott (2013) showed that US companies led by CEO overconfidence were positively related to restatement of financial reporting. Likewise, Koloub & Shoorevarz (2015) shows that CEO overconfidence has a positive effect on the restatement of financial reporting with a sample of public companies in Tehran. CEO overconfidence has a tendency to do restatement because CEO overconfidence is very optimistic about its ability to achieve certain targets so that it ignores a number of risks that will arise and believes in targets that are actually less realistic about the company’s financial condition (Hribar & Yang, 2016). In addition, Presley & Abbott (2013) states that material misstatements that arise in financial reporting are caused by the CEO having the rationalization that he is able to bring the company's performance forward much better so that it can cover up the mistakes of the previous financial reporting. Based on the description above, the first hypothesis of this study is stated as follows:

H1: Companies led by CEO overconfidence have a tendency to restatement of financial reporting.

The Relationship of Founder, CEO overconfidence and Restatement of Financial Reporting

The company led by the CEO founder has some positive values for the company because the CEO founder has a high sense of ownership of the company, avoids doing activities that are detrimental to the company, tends to be careful in maintaining the company’s reputation in the future because the CEO founder considers the company he or she founded as a one form of life achievement that can be continued in the next generation (Fahlenbrach, 2009; Chen et al., 2010). In addition, Ali et al. (2007) states that the CEO founder has a longer period of time in the company than the professional CEO so that the CEO founder has a positive value and tries to maintain the company's reputation in the long run. However, Lee et al. (2017) show that the founder has high overconfidence characteristics so that he has the courage to take risks, including having an optimistic attitude towards the company's future financial performance which is expected to cover up the fraudulent acts of financial reporting.

In contrast, Chin et al. (2017) show the impact of restatement on declining company performance, however the impact is reduced if the company is controlled by the family. Companies controlled by the family will pay more attention to the reputation and survival of the company in the future. Thus, a company led by CEO founder will be able to mitigate the positive relationship between CEO overconfidence and restatement of financial reporting. Based on the description above, the second hypothesis is stated as follows:

H2: CEO founder weakens the positive relationship between CEO overconfidence and restatement of financial reporting.

RESEARCH METHOD

Data Collection Techniques

This research data is in the form of secondary data, the financial reporting of non-financial companies listed on the Indonesia Stock Exchange in the period 2013-2018. Data obtained from the Indonesia Stock Exchange website (www.idx.co.id). The sample used in this study is based on certain sampling selection criteria with the following criteria:

1. Non-financial companies listed on the Indonesia Stock Exchange during the period 2013-2018;
2. Companies that report complete of financial reporting.

Data Analysis Method

Hypothesis testing in this study was tested using logistic regression analysis. Logistic regression analysis is used to examine the relationship between the independent variables and the dependent variable in the form of dummy.

Research Variable

CEO Overconfidence

CEO overconfidence is measured comprehensively based on research (Kouaib & Jarboui, 2016) by combining several measurement proxies that have been adjusted to the context of conditions in Indonesia:

(1) Overinvestment is the amount of investment made by the company. CEO overconfidence prefers overinvestment to enhance professional reputation and achieve expected targets without paying close attention to risk (Malmendier & Tate, 2005, 2008). The formula for calculating overinvestment is as follows:

\[ \Delta \text{Asset}_{t+1} / \text{Asset}_{t+1} = \alpha_0 + \beta_1 \Delta \text{Sales}_{t+1} / \text{Sales}_{t+1} + \epsilon \]

b. Reducing the residual value of regression of total asset growth and sales growth with the median residual value of the industry for the year. A value of 1 if the company's residual value is greater than the median of industrial residuals, a value of 0 if vice versa.

(2) Debt to equity ratio (total liabilities divided by total equity). Malmendier et al. (2011) show that CEO overconfidence likes external funding in the form of debt to fund investment activities undertaken. A value of 1 if the debt to equity ratio is greater than the industry median of the year, while a value of 0 if vice versa.

(3) Dividend yield is the payment of dividends by companies. CEOs with overconfidence characteristics have a reluctance to pay dividends because they prioritize the use of funds for corporate investment activities (Deshmukh et al., 2013). A value of 1 if dividend yields are zero and a value of 0 if vice versa.

CEO overconfidence measurement by combining the three measurement proxies above is intended to get a more comprehensive and accurate value. A company is categorized as being led by a CEO overconfidence if it has a combined value of greater than two.

CEO Founder

CEO founder is a CEO who is the founder or family member of the company's founder (Block, 2010). CEO founders will try more to maintain the company's reputation and sustainability going forward than CEOs who come from professionals (Chen et al., 2010). This study categorizes the CEO founder who is the founder or family member of the founder (child or sibling).
who has blood relations. Blood relations between family members such as parents, children and siblings are judged to have a strong emotional aspect compared to family relationships due to marriage such as husband or wife bond and parent-in-law relationship (Casson, 1999). CEOs who are founders or founding family members have a higher sense of ownership of the company.

**Restatement of Financial Reporting**

The company conducts a restatement of financial reporting on the grounds, 1) there are material errors in the previous financial reporting; 2) material errors in the financial reporting that are not detected by the company's internal audit; 3) material errors in the financial reporting that are not detected by the external auditor; 4) material misstatement that requires correction and restatement (Eilifsen & Messier, 2000). A value of 1 if the company performs a restatement of financial reporting in the year that follows, except for the restatement of changes in accounting standards and discontinued of business operations, value 0 if vice versa.

**Research Models**

The research model is described as follows:

\[
RE = \beta_0 + \beta_1 \text{CEOOVER} + \beta_2 \text{FOUNDER} + \beta_3 \text{CEOOVER} \times \text{FOUNDER} + \beta_4 \text{LEV} + \beta_5 \text{MTB} + \beta_6 \text{ROA} + \beta_7 \text{GROWTH} + \beta_8 \text{LOSS} + \varepsilon
\]

Information:

RE: Restatement of financial reporting (value 1 if the company restarts financial reporting, value 0 if vice versa).
CEOOVER: CEO overconfidence (merging 3 proxies: overinvestment, debt to equity ratio, dividend yield), value 1 if two of three proxies have a greater value than the industry median).
FOUNDER: Founding CEO, value 1 if the company is led by founding CEO, value 0 if vice versa.
CEOOVER * FOUNDER: Interaction between CEO overconfidence and CEO founder.
LEV: Leverage (debt to total assets, t).
MTB: Market to book value.
ROA: Return on assets (earnings before interest & tax / total assets, t).
GROWTH: Company growth (sales growth)
LOSS: Companies that report net losses (value 1), while the value 0 if vice versa.

**RESEARCH RESULTS**

**Descriptive Statistics**

This study uses a sample of non-financial companies listed on the Indonesia Stock Exchange for the period of 2013 - 2018. The following results are descriptive statistics in this study:

<table>
<thead>
<tr>
<th>Variable</th>
<th>Mean</th>
<th>Std. Dev.</th>
<th>Min</th>
<th>Max</th>
</tr>
</thead>
<tbody>
<tr>
<td>Restatement</td>
<td>0.174941</td>
<td>0.380366</td>
<td>0</td>
<td>1</td>
</tr>
<tr>
<td>Overconfidence</td>
<td>0.552969</td>
<td>0.497305</td>
<td>0</td>
<td>1</td>
</tr>
<tr>
<td>Founder</td>
<td>0.234816</td>
<td>0.423999</td>
<td>0</td>
<td>1</td>
</tr>
<tr>
<td>LEV</td>
<td>0.336158</td>
<td>0.647049</td>
<td>0</td>
<td>12.65</td>
</tr>
<tr>
<td>MTB</td>
<td>3.160582</td>
<td>6.967215</td>
<td>-4.76</td>
<td>53.59</td>
</tr>
<tr>
<td>ROA</td>
<td>0.080438</td>
<td>0.145734</td>
<td>-0.53504</td>
<td>0.752057</td>
</tr>
<tr>
<td>GROWTH</td>
<td>0.189077</td>
<td>1.30975</td>
<td>-1</td>
<td>22.3815</td>
</tr>
<tr>
<td>LOSS</td>
<td>0.270488</td>
<td>0.444324</td>
<td>0</td>
<td>1</td>
</tr>
</tbody>
</table>

Restatement is restatement of financial reporting, value 1 if the company does restatement, value 0 if vice versa. Overconfidence is a combination of measurement of overconfidence characteristics consisting of overinvestment, debt to equity ratio and dividend yield. Overconfidence has a value of 1 if two of the three components of overconfidence characteristics are met and a value of 0 if vice versa. Founder is a company led by the company's founder CEO, a value of 1 if the company is led by a CEO founder, a value of 0 if vice versa. LEV is measured by the value of debt to total assets. MTB (Market to Book) describes the ratio of market value divided by the book value of equity. ROA (Return on Assets) shows the profitability of the company. The GROWTH value indicates the company's sales growth rate. LOSS: Companies that report net losses (value 1), value 0 if vice versa. Numbers of MTB, ROA and GROWTH have been done winsorizing (1, 99) to overcome outliers.

From the results of the descriptive statistics above, it shows that the average sample of observational data that did restatement of financial reporting was 17.49% while the remaining 82.51% did not do restatement. The average sample of observation data led by CEO overconfidence was 55.30% while 44.70% of the sample of observation was led by CEO who did not have overconfidence characteristics. The observation data sample that has CEO founder is 23.48%, while 76.52% of the observation data sample is led by professional CEOs. The average value of leverage is 33.61%, while the average value of the market to book is 3.16. The average value of return on assets (ROA) in the observation data sample of this study is 8.04% and the average value of company growth (GROWTH) is 18.91%. Average companies that report losses are 27.05%.
Hypothesis Testing

The following are the results of testing the hypothesis of this study using logistic regression because the dependent variable is a dichotomous variable:

<table>
<thead>
<tr>
<th>Table 4.2 Testing Logistic Regression</th>
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<tbody>
<tr>
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<tr>
<td>Coeff.</td>
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<tr>
<td>Overconfidence</td>
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<tr>
<td>Founder</td>
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<tr>
<td>Overconfidence*Founder</td>
</tr>
<tr>
<td>LEV</td>
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<tr>
<td>MTB</td>
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<tr>
<td>ROA</td>
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<td>GROWTH</td>
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<tr>
<td>LOSS</td>
</tr>
<tr>
<td>Cons</td>
</tr>
<tr>
<td>Number of obs</td>
</tr>
<tr>
<td>LR chi2</td>
</tr>
<tr>
<td>Prob &gt; chi2</td>
</tr>
<tr>
<td>Pseudo R2</td>
</tr>
</tbody>
</table>

***sig. 1%, **sig. 5%, *sig. 10%

Hypothesis 1 of this study examines whether companies led by CEO overconfidence have a tendency to restatement of financial reporting. The results of this study on H1 showed a p-value ≤ 0.05 on the three forms of regression models, so that H1 could not be rejected statistically. Thus the results of this study indicate the probability of the tendency of companies led by CEO overconfidence to restate financial reporting. This is because CEO overconfidence has the characteristics to dare to take risks excessively, tends to commit fraud and earnings management to demonstrate its ability to exceed targeted expectations. In testing the three models above, the results of this study show robust results that companies led by CEO overconfidence have a tendency to restate financial reporting.

In the partial test of CEO founder, the tendency to do restatement shows the result of p-value ≥ 0.05 which shows that CEO founder does not encourage the restatement of financial reporting. Likewise, the results of testing the moderation relationship between CEO overconfidence, founder and restatement of financial reporting show that the founder does not affect the relationship between CEO overconfidence and the tendency of restatement of financial reporting. The H2 test results show a p-value ≤ 0.01, which means that the CEO founder was actually able to weaken the positive relationship between CEO overconfidence and the tendency for the restatement of financial reporting. This is because the CEO who is the founder of the company will be more careful in maintaining the company's reputation and long term sustainability so that even though the company's CEO has the characteristics of overconfidence, at the same time the company's founder will reduce the tendency for restatement of financial reporting.

Testing of control variables tested in this study shows that companies with high leverage or debt levels have less tendency to restate financial reporting as evidenced by p-value ≤ 0.05. Otherwise, MTB has a p value ≤ 0.1, which means that companies with a high MTB tend to conduct a restatement of financial position. While the profitability (ROA) of the company, the level of sales growth of the company (GROWTH) and the company that experienced a loss (LOSS) has a p-value ≥ 0.05 which means that profitability, sales growth and losses experienced by the company does not encourage the greater opportunity for the company to restate financial reporting.

Robustness testing is done by testing the hypothesis using random-effects logistic regression, the results of which show findings that are not different from the previous test, as shown in the following table 4.3.
The test results indicate that companies led by CEO overconfidence have a tendency to perform restatement of financial reporting. CEO overconfidence has a cognitive bias that encourages a high level of courage in taking risks so that it can harm the company. Meanwhile, the founder has no influence on the restatement of financial reporting. Similar to the findings in previous tests, the CEO founder weakens the positive relationship between CEO overconfidence and restatement of financial reporting. The results of this study indicate that CEO founders can become one of the corporate governance mechanisms that are predicted to align with the company's interests because founders have a high sense of belonging to the company so that they will not take actions that can harm the company itself. Amit & Villalonga (2006); Fahlenbrach (2009) stated that CEO founder is considered to be able to maximize value for the company.

CONCLUSIONS, IMPLICATIONS AND SUGGESTIONS

This study examines whether companies led by CEO overconfidence have a tendency to restatement of financial reporting. The results of this study indicate that the probability of companies led by CEO overconfidence shows a tendency to do restatement of financial reporting. This is because CEO overconfidence has the characteristics to be too brave in taking high risks or cheating on financial reporting such as manipulating earnings, causing companies to represent their financial reporting. In further testing, this research shows that companies led by CEO founders do not have a tendency to restate financial reporting. This is because the restatement of financial reporting is more influenced by other factors.

In testing the moderating relationship of the CEO founder to the relationship between CEO overconfidence and restatement of financial reporting shows that the company led by the CEO founder will weaken the positive relationship between CEO overconfidence and restatement of financial reporting. This shows that the CEO founder will be more careful in carrying out the company’s operations including in presenting the company’s financial reporting. In addition, the founder will put more effort in maintaining the company's reputation and long term sustainability so that even though the CEO has the characteristics of overconfidence, if the company's CEO is a founder will have a smaller tendency for the restatement of financial reporting. The CEO founder has a strong sense of belonging and thinks the company is a life achievement.

The implication of this study is for auditors when determining audit risk and users of financial reporting in making a decision to pay more attention to the characteristics of company leaders because one of the characteristics of corporate leaders, overconfidence will have a tendency for the restatement of the company's financial report. While companies led by CEO founders can mitigate the positive relationship between CEO overconfidence and restatement of the financial reporting. Thus the CEO can be a good corporate governance mechanism for the company because the CEO founder will try to align interests with the company.

The limitation of this study is that it has not categorized the causes of restatement of financial reporting. For further research, it is better to categorize the causes of restatement of financial reporting and calculate the magnitude of the impact of restatement of financial reporting on profit or loss. In addition, further research can examine the existence of the board of commissioners and the audit committee that can mitigate the relationship between CEO overconfidence and the restatement of financial reporting because the board of commissioners and the audit committee is predicted to have a significant role in good corporate governance.

REFERENCES


