



## Half Full, and Then Some

**New research suggests that CFOs, like CEOs, can be confident to a fault.**

[Alan Rappeport](#), CFO Magazine

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Confidence is in short supply these days. The prospect of a lengthy recession has left just about everyone feeling nervous and insecure. Finance chiefs in particular are gloomier than ever, as indicated by *CFO* magazine's recent Business Outlook surveys, which found that nearly 90 percent don't anticipate a return to normal growth conditions until late 2009.

Yet, in spite of justified anxieties about the economy, CFOs generally remain an optimistic bunch. In fact, the typical CFO is *too* confident, according to Itzhak Ben-David of the University of Chicago Graduate School of Business.

The corporate Dr. No is really Dr. Yes in disguise? It's hard to imagine. Yet, in a new paper, Ben-David, along with John Graham and Campbell Harvey, professors at Duke University's Fuqua School of Business, suggest that, on average, CFOs are overconfident. Overconfident finance chiefs tend to use lower discount rates when valuing cash flows and assign higher values to projects. Their companies invest more, use more debt, and are less likely to pay dividends. Multitasking is a hallmark, too, as overconfident CFOs tend to take on many projects at once.

How do you locate the boundary between confidence — a necessary quality in every manager — and overconfidence? Ben-David and his colleagues did so by measuring bets on the stock market. The authors surveyed 7,000 CFOs over a six-year span, asking them to predict a range of 1- and 10-year returns of the S&P 500 index and divulge how certain they felt about their predictions. Although most of the CFOs felt very sure of themselves when selecting, they were correct just 38 percent of the time. The level of certainty that a CFO felt about his stock pick, and the frequency of his misjudgments, correlated to his level of confidence.

To overconfident CFOs, risky projects seem safer than they really are. "Overconfident managers underestimate risk and therefore take actions with excessive risk," write the professors. Of course, managers who take risks that succeed are rewarded, rising in the corporate hierarchy. "It's easier to climb the organizational ladder if you're confident," says Ben-David, who will join the Ohio State University Fisher College of Business in June.

Brimming with self-assurance, cocky CFOs often underestimate competitors and the wisdom of the market, says Ben-David. When making financing choices, they might incorrectly price the firm's securities, as they assume the market is undervaluing the company's worth. (This assumption also explains their penchant for repurchases.) Overconfidence can wreak havoc on mergers, too, as faith in synergies overshadows real obstacles. "When overconfident CFOs announce mergers, they usually have a negative market announcement return," Ben-David says.

### Overconfidence Men?

Can a CFO's overconfidence lead to mischief? It's a slippery slope, according to Catherine Schrand and Sarah Zechman, of the University of Pennsylvania's Wharton School of Business. In a new working paper, Schrand and Zechman define overconfidence as having "unrealistic positive beliefs" about an uncertain outcome. This bias, they say, is often revealed in financial reports where earnings have been managed. When that happens, outright fraud may be right behind.

To make the link, they use Accounting and Auditing Enforcement Releases issued by the Securities and Exchange Commission between 1996 and 2003 to determine cases and causes of fraudulent behavior. Finding that fraud is most prevalent in industries with high growth and volatility, they compare samples of companies that committed fraud in those industries with companies that did not.

Of the companies with violations, Schrand and Zechman found that their crimes often began with overconfidence about the future. Executives would fudge their statements just a little in one quarter, when earnings were weak, presuming that things would improve later on. But sometimes matters grew worse. "Eventually, the manager's only option is to 'cook the books' by falsifying documents and making the kinds of accounting misstatements that are prosecuted by the SEC," they write.

Schrand points to computer-maker Gateway as an example of overconfidence gone wrong. In 2000, Gateway's revenues were sagging because it kept turning away customers who wanted to finance their purchases. To boost its numbers, the company began offering credit to people who did not necessarily deserve it. A short-term fix became a big-time problem as Gateway needed to continue the growth in sales that it manufactured through its loan program. The company continued doling out credit, and when it failed to disclose what was happening, the SEC nabbed it. "If they thought the [credit] program would have reached \$50 million, I don't think they would have done it," says Schrand.

### **Great Expectations**

Despite the dangers of overconfidence, many people contend that it's better to have too much confidence than too little. "All executives need to have a pretty good level of confidence in what they're doing," says Jerry York, who displayed ample self-assurance as the CFO of Chrysler and IBM in the 1990s. "They need to try to bring out the best in the people around them in the company, but also collect input from sources outside the company." Still, confidence can cut both ways. Says York, "Someone who is overconfident but is not very capable is someone who is a danger to any enterprise."

Last year Simon Gervais, of Duke University, and Itay Goldstein, of the University of Pennsylvania, made a case for the virtues of overconfidence. They wrote in the *Review of Finance* that people who overestimate their skills tend to work harder and be more productive in order to meet their own expectations. They also contend that overconfident executives inspire their colleagues and, contra Ben-David, argue that they can be valuable when negotiating mergers. Those with an inflated sense of their company's worth will drive a hard bargain and, whether buying or selling, are more likely to get the best deal.

Perhaps John Maynard Keynes made the most forceful case for confidence when he wrote, "Individual initiative will only be adequate when reasonable calculation is supplemented and supported by animal spirits." The eminent British economist observed that successful businessmen embrace a "naive optimism" and must put aside the thought of ultimate loss, just as healthy men put aside the thought of death.

Ultimately it might be a matter of kind rather than degree. Confidence comes in various shades, making it both an asset and a liability for an executive, depending on the situation. Finance chiefs often consider self-assurance to be a core competency. "We accept what these CFOs are saying," says Schrand. "The positive benefits of overconfidence for some tasks might outweigh the negative consequences for other tasks."

A healthy dose of confidence, of course, is the glue of the markets. A failure of confidence can result in that perennial Wile E. Coyote sight-gag, where momentum meets gravity. The crash of Bear Stearns in March was the result of a "lack of confidence, not a lack of capital," according to SEC chairman Christopher Cox.

For companies, the missing factor in the confidence equation might be self-awareness. As York notes, executives must be good at gathering information from many sources and listening to what they are told. Better stress testing of potential outcomes can improve decision making, and knocking more heads together can dislodge stubborn certainty. Like everything else, overconfidence must be factored into the overall management picture. "It's not that overconfidence is bad," says Schrand. "It's that it should be recognized."

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### **Warning Signs**

Hallmarks of companies with overconfident CFOs

- Use lower discount rates to value cash flows
- Invest more
- Use more debt
- Less likely to pay dividends
- More likely to repurchase shares
- Use proportionately more long-term debt

*Source: "Managerial Overconfidence and Corporate Policies," by Itzhak Ben-David, John R. Graham, and Campbell R. Harvey. NBER Working Paper Series, 12/07*