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# Overconfidence and tax avoidance: The role of CEO and CFO interaction

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ABSTRACT

We investigate how overconfident CEOs and CFOs may interact to influence firms' tax avoidance. We adopt an equity measure to capture overconfident CEOs and CFOs and utilize multiple measures to identify companies' tax-avoidance activities. We document that CFOs, as CEOs' business partners, play an important role in facilitating and executing overconfident CEOs' decisions in regard to tax avoidance. Specifically, we find that companies are more likely to engage in tax-avoidance activities when they have both overconfident CEOs and overconfident CFOs, compared with companies that have other combinations of CEO/CFO overconfidence (e.g., an overconfident CEO with a non-overconfident CFO), which is consistent with the False Consensus Effect Theory. Our study helps investors, regulators, and policymakers understand companies' decision-making processes with regard to tax avoidance.

*"CEOs need a CFO who can help management confidently take new, calculated risks and strategize ways to grow the business."*
Kathy Crusco, CFO of Crusco (2016)

## 1. Introduction

Overconfidence has been found to be a common personal trait among CEOs and may have an effect on CEOs' investment decisions and financial reporting choices (Goel and Thakor, 2008). Upper Echelons theory suggests that organizational behaviors reflect the personal traits of top executives (Hambrick, 2016; Hambrick and Mason, 1984),[1] and CEO overconfidence may play an important role in corporate policy setting and strategic decisions. The literature has shown that companies with overconfident CEOs are more likely to have higher-level investments (Brown and Sarma, 2007; Malmendier and Tate, 2005, 2008), more innovative activities, and greater innovation success (Galasso and Simcoe, 2011; Hirshleifer et al., 2012) relative to companies with non-overconfident CEOs. Overconfident CEOs also need stronger cash inflows as compared to non-overconfident CEOs to satisfy their investment and innovation funding needs (Richardson, 2006).

Prior studies, however, also document that overconfident CEOs tend to overestimate their ability to generate earnings, which may

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[1] Hambrick (2016) explains upper echelons theory as that top executives use their own highly personalized lenses to understand companies' strategic situations including opportunities, threats, alternatives, and likelihoods of various outcomes. These individualized understandings are based on executives' experiences, values, personalities, and other human factors. Thus, according to the theory, organizations become reflections of their top executives.

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create discrepancies between companies' real performance and their earnings expectations, resulting in the management of financial results to meet their expectations and satisfy their confidence needs (Gilson, 1989; Hribar and Yang, 2016; Hsieh et al., 2014; Schrand and Zechman, 2012). Tax avoidance may serve as an effective earnings management tool for companies to meet their earnings target, while alleviating their tax burden and increasing cash flows (Desai and Dharmapala, 2009; Halon, 2005; Phillips et al., 2003). Therefore, overconfident CEOs are more likely to promote tax avoidance, which is reflected in lower corporate effective tax rates (Olsen and Stekelberg, 2015).

Although the impact of CEO overconfidence on corporate decision-making processes is understood, it should be noted that CEOs may rely on CFOs to execute their financial reporting decisions (Jiang et al., 2010). Feng et al. (2011) also suggest that CFOs use their financial expertise to manipulate earnings because they succumb to pressure from CEOs for earnings management. Practitioners also recognize the importance of CFOs in financial reporting-related issues and call for closer scrutiny of the backgrounds and qualifications of CFOs who assist CEOs, as their business partners, in their decision-making processes (Cox, 2013; Egon Zehnder, 2016).

AESC (2015) argues that CFOs should possess the right chemistry (e.g., matched personality traits and similar beliefs) to collaborate with CEOs for the most effective and efficient management of the company. This contention is consistent with the False Consensus Effect, a psychological theory posits that people tend to selectively expose themselves to those who possess similar personality traits and, thus, share similar beliefs and values (Bahns et al., 2017). This selective exposure may lead to a cognitive bias of judgmental consensus in a social environment and, thus, exaggerate the overconfidence effect in a social relationship for people who share similar personality traits (Aronson et al., 2015; Bauman and Geher, 2002). Following these arguments, we investigate whether companies are more likely to engage in tax-avoidance activities when they have both an overconfident CEO and overconfident CFO, relative to other CEO/CFO combinations as based on their overconfident personality traits.

We adopt an equity-based overconfidence measure (*NETBUYER*) (Campbell et al., 2011; Malmendier and Tate, 2005) to identify overconfident CEOs and CFOs. We also adopt two long-term tax-avoidance measures, *ETR5* and *CETR5* (Dyreng et al., 2008), to test our research hypothesis. Our results suggest that companies with both overconfident CEOs and overconfident CFOs exhibit the highest level of tax-avoidance relative to the other CEO and CFO overconfidence combinations, supporting our argument that overconfident CEOs set the tone at the top to promote tax avoidance, while overconfident CFOs play an important role in executing the tax-avoidance guidance issued by overconfident CEOs.

Our study contributes to the accounting literature by providing empirical evidence that the interaction between CEOs and CFOs influence companies' tax avoidance strategies. Previous studies tend to focus only on the effects of CEOs' fixed effects or personal characteristics on firms' accounting-related decisions. However, accounting-related decisions are more likely to be controlled or influenced by CFOs due to their financial expertise and their changing role in contemporary business environment from traditional financial planning to strategic planning in support of companies' strategic goals. Our study, which provides early evidence about the role of CFOs in this association, helps investors understand companies' decision-making processes in terms of tax reporting. It also helps regulators identify potential factors that might cause losses of total tax revenue, leading them to more effectively regulate companies' tax reporting by taking into account the management style of both CEOs and CFOs.

The remainder of this paper consists of the following sections. The next section provides a synthesis of related studies and develops the research hypotheses. This is followed by a discussion of the research methods. The subsequent section presents the results. We conclude our study by discussing the results and presenting directions for the future research.

## 2. Literature review and hypothesis development

### *2.1. Tax avoidance*

Tax avoidance refers to corporate activities that result in any "reduction in explicit taxes," including adopting different legal (even possibly illegal) tax strategies (Dyreng et al., 2008, 2010; Hanlon and Heitzman, 2010). Tax avoidance, tax planning, and aggressive tax reporting have been compared and used interchangeably to describe corporate tax-avoidance activities (Frank et al., 2009).

The corporate tax-avoidance has been widely studied in the accounting, taxation, finance, management and law literature. Previous studies have found an increase in tax avoidance in U.S.-based public companies and a substantial variation in the levels of companies' tax avoidance (Dyreng et al., 2008; Frank et al., 2009). According to Duff (2009), tax avoidance would allow firms to defer or permanently eliminate their tax liability. For example, companies may convert a taxable item, such as dividends received from capital investments, to a tax-exempt one, such as interest received from municipal bonds investments. Companies also may transfer income to other regions or countries to obtain a relatively lower tax rate. As a result, firms pay less tax and realize greater cash flows to satisfy their needs for investments, acquisitions, and other business activities.

As suggested by Shackelford and Shevlin (2001), there is a tradeoff between aggressive financial reporting and tax avoidance. Theoretically, higher taxable income should be associated with higher net income. Thus, firms have to sacrifice tax benefits for better financial results and vice versa. Firms' earnings numbers, however, are not always positively associated with their taxable income (e.g., Boynton et al., 2005; Frank et al., 2009; Hanlon et al., 2005). Increased financial income that is associated with decreased taxable income might represent abnormal earnings manipulation activities and tax avoidance (Halon, 2005; Phillips et al., 2003).

Firms' tax reporting can also be influenced by firm-specific factors. Klassen (1997) finds that firms' insider equity ownership is positively associated with aggressive tax reporting for high tax-rate firms. He argues that increased insider ownership concentration, as a firm-specific characteristic, reduces pressure and public scrutiny from external investors, thus motivating managers to behave more aggressively to satisfy their self-interests. Chen et al. (2010) find that family-owned firms tend to forgo tax benefits and behave less aggressively in regard to their tax reporting, relative to non-family-owned firms, to avoid other non-tax costs and potential