

## **Managerial Overconfidence, Conservative Accounting and Corporate Investment**

Keiichi Shima (Mie University)

Jun-ichi Nakamura (Development Bank of Japan)

We examine the link between managerial overconfidence, conservative accounting and investment. Using Japanese firm data, we estimate a q-investment model incorporating real options effects. Consistent with the prior studies, we find that managerial overconfidence increases investment-cash flow sensitivity. On the other hand, we find mixed results regarding the relationship between managerial overconfidence and real options. We proxy sales growth for investment return growth and find that firms' investment is positively related to sales growth and negatively related to its volatility. We also find that managerial overconfidence increases both positive sensitivity of investment to sales growth and negative sensitivity of investment to sales growth volatility.

In addition, we examine whether conservative accounting mitigates agency costs and investment distortions after controlling for the effect of managerial overconfidence on investment. Contrary to prior studies, we find that conservative accounting increases investment-cash flow sensitivity. However, our results confirm that conservative accounting significantly reduces investment-cash flow sensitivity for firms with managerial overconfidence.