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Effects of CEO Overconfidence to Equity Incentives on Sharia Firms in Indonesia and Malaysia

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Abstract

This study aims to research about the effects of CEO overconfidence on equity incentives in sharia firms listed on the Indonesia and Malaysia Stock Exchange from 2019 to 2023. CEO overconfidence is measured using two proxies: ownership value (management shareholding) and leverage ratio. Equity incentives are assessed using a dummy variable indicating the presence of stock-based compensation. The study also includes financial performance ratios as control variables—Return on Assets (ROA), Earnings Per Share (EPS), Price to Book Value (PBV), and Price to Earnings Ratio (PER). Panel data regression employing the Seemingly Unrelated Regression (SUR) approach is used for analysis. The results indicate that both ownership value and leverage have a positive and significant impact on equity incentives, suggesting that overconfident CEOs are more likely to receive stock-based compensation. Meanwhile, ROA, EPS, and PBV show no significant impact, while PER has a significant negative impact. These findings highlight the importance of CEO psychological traits in shaping executive compensation structures and contribute to the development of behavior-based agency theory in the context of Sharia enterprises.

Keywords: *Agency Theory, Equity Incentives, Overconfidence, Ownership Value, Sharia Firms*

INTRODUCTION

Equity incentives play a critical role in modern corporate governance by aligning the interests of management with those of shareholders. In Islamic firms, particularly in Indonesia and Malaysia—the two countries with the largest Muslim populations—these mechanisms must comply not only with economic principles but also with Sharia guidelines. One factor that might be influencing this is the trait of the CEO, especially those who are overconfident. Overconfident CEOs tend to overestimate their decisions, which may affect the firm's performance and their compensation structure. This study explores how CEO overconfidence, proxied by ownership value and leverage ratio, affects the likelihood of receiving equity-based compensation in Sharia-compliant firms across Indonesia and Malaysia.

LITERATURE REVIEW

Agency Theory

Agency theory, introduced by (Jensen & Meckling, 1976), describes the relationship between the principal (shareholders) and the agent (management). Differences between them might cause problems and conflicts arise. To mitigate this, equity-based incentives are often employed to align managerial actions with shareholder interests. When CEOs possess financial stakes in the firm—such as stock options or ownership—they are more likely to act in accordance with the shareholder's view, thereby reducing agency costs (Beal Partyka, 2022).

(Zogning, 2017) emphasizes that agency theory plays a crucial role in designing incentive mechanisms that align goals under uncertainty. However, its effectiveness can be compromised by managerial psychological traits, especially overconfidence. Overconfident CEOs may overestimate their abilities or the accuracy of their decisions, leading to decisions that deviate from rational expectations—even in the presence of equity incentives ((Hendrastuti & Harahap, 2023); (Panda & Leepsa, 2017)). Therefore, modern applications of agency theory increasingly incorporate behavioral finance insights to better understand agent behavior.

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CEO Overconfidence

CEO overconfidence refers to a cognitive bias wherein an executive overestimate their knowledge, predictive abilities, or level of control over outcomes. This trait often manifests excessive optimism in strategic decisions, especially under uncertainty (Malmendier U & Tate G, 2015). CEOs with high overconfidence tend to undertake aggressive investment strategies, rely more heavily on debt financing, and exhibit resistance to external advice ((Sharpe et al., 2023); (Aktas et al., 2019)).

Psychologically, overconfidence stems from foresight bias and hindsight bias—overestimating one's predictions of future events or interpreting past events with a false sense of accuracy (Pohl, 2022). Other behavioral dimensions include the better-than-average effect and illusion of control, where individuals believe they have superior skills and influence over outcomes (Pikulina et al., 2017). In corporate settings, this bias may lead to suboptimal financial decisions, including over-leveraging and underestimating risk.

Although some studies argue that overconfident CEOs can be innovative and forward-looking, others caution that unchecked overconfidence can erode firm value ((Kaplan et al., 2022); (Garcia et al., 2022)). Hence, it is essential to measure and manage overconfidence through governance and compensation structures.

Equity Incentives

Equity incentives are compensation mechanisms that tie executive rewards to firm performance, often in the form of stock options, restricted stock units, or performance shares (Chen, 2019). These instruments are designed to motivate executives to increase shareholder value and to internalize the outcomes of their decisions. As ownership and control are separated in modern corporations, equity incentives serve as a bridge to reduce the principal-agent gap (Ma & Wang, 2022).

In Islamic firms, these incentives must also comply with Sharia principles, avoiding speculation, interest (riba), and unjust enrichment. Despite this constraint, equity incentives remain essential in encouraging long-term thinking among executives.

However, the literature reveals a nuanced interaction between equity incentives and CEO overconfidence. Some studies find that overconfident CEOs value equity compensation more, as it aligns with their optimistic view of future firm performance ((Sharpe et al., 2023); (Sun & Xia, 2022)). Others suggest that overconfident executives might overvalue their own contributions and seek higher equity stakes, potentially leading to excessive risk-taking ((Chen, 2019); (Humphery-Jenner et al., 2016)). The effectiveness of equity incentives, therefore, is contingent upon both the structure of the incentive and the psychological traits of the recipient.

Company Performance

Company performance is commonly assessed through both accounting-based and market-based indicators. Financial metrics such as Return on Assets (ROA) and Earnings Per Share (EPS) reflect operational efficiency and profitability, while market ratios such as Price to Book Value (PBV) and Price Earnings Ratio (PER) indicate investor perceptions of growth and valuation ((Purwanti, 2021); (Firdaus & Kasmir, 2021)).

ROA measures how effectively a firm converts its assets into net income and is often used as an internal benchmark for managerial performance (Chandra et al., 2023). EPS, on the other hand, provides insight into per-share profitability and is closely watched by investors for earnings forecasts.

PBV and PER serve as external market signals. PBV indicates whether a firm's stock is valued above or below its book value, reflecting growth expectations ((Suyanto, 2021); (Veronica, 2022)). PER expresses how much investors are willing to pay for each unit of earnings, acting as a proxy for market optimism or skepticism (Rahmawati & Hadian, 2022). However, excessively high market valuations may discourage firms from issuing new shares as equity incentives, due to dilution concerns (Sari et al., 2021).

While these performance measures are frequently used as control variables in compensation studies, their direct effect on equity incentive decisions may be limited, especially when psychological traits such as overconfidence dominate the decision-making process.

Research Method

This quantitative study uses panel data from 35 non-financial Sharia-compliant firms listed on the Indonesia Stock Exchange (IDX) and Bursa Malaysia during the 2019–2023 period, resulting in 170 firm-year observations. The dependent variable is equity incentive, measured as a dummy variable (1 = firm offers equity-based compensation; 0 = otherwise). Independent variables include ownership value (percentage of shares held by the CEO) and leverage ratio (debt-to-equity ratio), both used as proxies for CEO overconfidence. Control variables include Return on Assets (ROA), Earnings Per Share (EPS), Price to Book Value (PBV), and Price Earnings Ratio (PER). The data are analyzed using panel data regression with the Seemingly Unrelated Regression (SUR) method to account for cross-equation error correlation and heteroskedasticity.

Research Results

The empirical findings reveal that ownership value and leverage ratio have a positive and statistically significant impact on the probability of a firm providing equity incentives. This supports the hypothesis that CEOs with greater confidence in their leadership and firm performance are more likely to accept and be offered equity-based compensation. Among the control variables, PER shows a negative and significant relationship, indicating that firms with higher market expectations may be less inclined to offer equity incentives due to potential dilution concerns. However, ROA, EPS, and PBV do not significantly influence the likelihood of providing equity incentives, suggesting that short-term financial performance is not a primary

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consideration in the design of such compensation in Sharia firms.

Conclusion

This study confirms that CEO overconfidence—measured through ownership and leverage—plays a significant role in the structuring of equity incentives in Islamic firms in Indonesia and Malaysia. The findings reinforce the importance of integrating psychological factors into agency theory and compensation design, especially in Sharia-compliant contexts where ethical considerations and governance norms are distinct. Policymakers and boards should account for executive overconfidence when designing incentive schemes to ensure alignment with long-term corporate goals and shareholder interests. Future research could extend this analysis to other emerging markets or include qualitative assessments of managerial behavior.

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