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Research Paper

Conservative Capital Structure and Stock Price Crash Risk: The Moderating Role of Information Asymmetry and Firm Life Cycle[1]

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INTRODUCTION

The research aims to explore the impact of capital structure determination policies, specifically conservative and non-conservative policies, on the risk of stock price crashes. Existing empirical and theoretical evidence suggests that companies favoring financial conservatism tend to have lower leverage, higher cash reserves, experience slower growth, and may face market repercussions due to excessive conservatism. Capital markets often react negatively to extreme conservatism. Consequently, it is hypothesized that a conservative capital structure increases the risk of future stock price crashes. Moreover, empirical findings indicate that information asymmetry allows managers to conceal unfavorable news, potentially resulting in a sudden stock price drop when the news is eventually disclosed. Theoretically, information asymmetry is linked to financial flexibility through reduced debt and increased cash, and conservative financial practices involve avoiding excessive investment of surplus cash and utilization of debt capacity. Therefore, it is anticipated that companies characterized by higher information asymmetry will exhibit a more pronounced effect of a conservative capital structure on the risk of future stock price crashes. Additionally, companies in the growth and introduction stages often prioritize investments for expansion, resulting in higher debt levels and lower cash reserves. In these growth stages, management is more likely to adopt a bold approach to capital structure. Given this context, a conservative capital structure in growth and introduction stages is expected to heighten the risk of stock price crashes. The research aims to investigate and analyze these expected impacts across different stages of a company's life cycle.

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MATERIALS AND METHODS

The current research is a quantitative, applied, and post-event study. Data were collected using the document mining method through the new Rahvard software, specifically by studying the audited financial statements of companies listed on the Tehran Stock Exchange. The statistical population was determined using the systematic elimination method, resulting in a sample of 143 companies after applying sampling restrictions. The research period spans from 2012 to 2021, and multivariable regression models were estimated, taking into account the fixed effects of both the year and industry.

RESULTS AND DISCUSSION

The findings of the research suggest that a conservative capital structure does not exert a significant impact on the stock price crash risk. Despite emphasizing the role of information asymmetry in the relationship between conservative capital structure and stock price crash risk, the life cycle of the company does not appear to have a significant effect on this relationship.

CONCLUSION

The research suggests that companies with a conservative capital structure are more likely to seize suitable investment opportunities, reduce opportunistic behavior, and face a lower risk of stock price crashes. This conclusion holds true even in Iran's inflationary economy. Supplementary tests indicate that the results remain consistent when debt related to facilities is considered in the calculation of financial conservatism.

The research further suggests that the average characteristics of companies with conservative and non-conservative capital structures, as measured by credit of net debt ratio and debt ratio based on facilities, can influence the results. Therefore, analysts and creditors are advised to take into account these ratios when assessing the risk of future stock price falls.

Additionally, the research model only considers the size of the company as a control variable. Future research is recommended to incorporate other control variables that may affect the risk of future stock price falls, thereby enhancing the explanatory power of the model. Moreover, using alternative indicators for measuring financial conservatism based on relevant criteria is suggested for future studies.

INNOVATION

The current study represents a pioneering analysis of the determinants of conservative financial policy. It breaks new ground by investigating the influence of a conservative capital structure on the risk of stock price crashes, incorporating considerations of life cycle adjustment and information asymmetry. This research contributes to the existing literature on financial conservatism, particularly in the context of inflationary economies, and sheds light on its nuanced effects.

Keywords: Conservative Financial Policy, Stock Price Crash Risk, Financial Flexibility, Information Asymmetry and Life Cycle.
JEL Classification: G32, O16, D53.

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