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Research Paper

Agency Costs and the Relationship between Financial distress Risk and the Stock Prices Crash Risk[1]

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INTRODUCTION

Managers do not disclose bad news about the company due to their desire and motivation to maintain wealth, reward contracts, and job security concerns. When the bad news reaches a certain level, the benefits of withholding bad news, despite the costs incurred, diminish, leading to a decline in stock market confidence and causing a stock price crash. On the other hand, financial distress and job security concerns among managers are reasons why they tend to consistently conceal bad news. Therefore, it is expected that an increased risk of financial distress will lead to a higher risk of stock price crashes. Additionally, agency relationships and conflicts of interest between managers and shareholders lead shareholders to tolerate agency costs to align interests and minimize conflicts. Thus, it is anticipated that agency costs influence the relationship between financial distress and the risk of stock price crashes. Accordingly, the impact of agency costs on the relationship between the risk of financial distress and the risk of stock price crashes has been examined. The study aims to investigate whether the risk of financial distress affects the risk of stock price crashes and how agency costs influence this relationship. Consequently, the following hypotheses have been tested.

HYPOTHESIS

First Hypothesis: Financial distress increases the risk of a stock price crash.

Second Hypothesis: Agency costs amplify the relationship between financial distress and the risk of a stock price crash.

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METHOD

This research investigates the descriptive-correlational relationship between financial variables using multi-variable regression models. The financial data of 211 companies listed on the Tehran Stock Exchange is analyzed for the period from 2012 to 2021.

RESULTS

To assess stock price crash risk using measures of negative skewness of stock returns and low-to-high volatility, financial distress risk was evaluated using Merton's criterion based on market information. The first hypothesis was not supported by these criteria, which may be attributed to market efficiency in the Tehran Stock Exchange, where Merton's criterion relies on market data—a crucial aspect given market orientation.

The rejection of the second hypothesis might stem from potential manipulation of company accounting information by management. In agency theory, managers, distinct from owners under transaction cost theory, often prioritize their own interests. This behavior may obscure information disclosures aligned with the opportunity-seeking theory, contributing to observable agency costs.

Given the absence of a relationship between financial distress risk and the risk of stock price decline moderated by agency costs, financial distress risk was recalculated using Altman's model based on accounting information from 1968. Subsequent models were re-estimated in additional tests. Management's timing of news related to financial distress influences market perception of the company's economic fundamentals and the potential for significant stock price declines.

CONCLUSION

The results indicate that financial distress risk (based on accounting information) increases the likelihood of a stock price crash. Thus, confirming the positive effect of financial distress on stock price crash risk suggests that heightened financial distress incentivizes managers to withhold negative news from investors, thereby increasing the likelihood of future stock price declines. Financial distress risk provides critical insights into near-term stock price crash risks. These findings align with those of Andre et al. (2021).

The degree of market efficiency can also influence the relationship between financial distress risk and the risk of stock price decline, as indicated by Merton's criterion based on stock market information.

Given the impact of agency costs on the relationship between financial distress risk and stock price crash risk, industry-level analysis can elucidate these dynamics. This hypothesis is consistent with the findings of Moradi and Karami (1398) and Mousavi et al.

Investors should consider financial distress analyses of firms when evaluating stock price crash risks. Increased oversight of firms facing financial distress risk is crucial to safeguard shareholder interests.

Keywords: Agency cost, Risk of financial distress, Stock prices crash risk.
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