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A Literature Review on Stock Price Crash Risk

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ABSTRACT

The sharp ascent and descent of prices in the stock market will disrupt the healthy trading order of the market, reduce the efficiency of resource allocation, and may lead to social and economic unrest. By investigating a large number of literature, this paper aims at identifying and analyzing the factors influencing the stock price crash risk. Finally, draw a conclusion and put forward the prospect. The determinants are categorized based on six factors: (i) Earnings management, (ii) Financial reporting comparability, (iii) Independent directors, (iv) Internal control, (v) Analysts, (vi) Institutional investors.

Keywords: *Stock price crash risk; Corporate governance; Financial reporting; External monitoring;*

1. INTRODUCTION

By definition, a stock crash refers to when stock managers do not disclose adverse news to the outside world. After the bad news is revealed, shareholders have to sell stocks if they do not buy more. As a result, a large number of stocks were sold, resulting in a precipitous drop of stock prices.

In recent years, abundant researchers have studied the causes of the stock crash of price risk and achieved certain results. It is universally accepted that stock crash of price risk mainly comes from the high degree of information asymmetry [1]. The information asymmetry of listed companies mainly comes from two aspects: the information asymmetry of shareholders themselves and the deliberate concealment of bad news by major shareholders or executives. When investors do not know enough about the company, they tend to have high expectations of its share price. Once the expectation is dashed, the share price collapse will follow. The company's major shareholders and senior managers may hide its bad operating conditions because of their own interests, but once this bad news flows into the market, it will cause the stock price to plunge instantly, followed by a stock crash of price.

An in-depth study of the potential for the stock crash of price risk found that the comparability of earnings management and financial reports significantly impacts the degree of information disclosure. In corporate governance, independent directors and internal control also control the stock crash of price risk. In terms of external monitoring, analysts and institutional investors also inhibited the stock crash of price risk.

In this paper, I aim to focus on three aspects, including financial reports, corporate governance and external monitoring. The remaining paper structures as follows: Section 2 reviews the link between the quality of information disclosed and the danger of a stock price fall. Section 3 examines whether corporate governance inhibits the stock crash of crash risk. Section 4 reviews external monitoring and the stock crash of crash risk. This paper can not only add to the body of knowledge in the subject of stock price risk, but also help external investors to strengthen their understanding of it and prevent this kind of situation. This paper analyzes its theoretical mechanism, measurement methods and influencing factors, and finally puts forward possible research directions, trying to make a certain contribution to the future research direction.

2. INFORMATION DISCLOSURE QUALITY

2.1 Earnings management

Earnings management is an important part of the company's internal management. Earnings management is the process by which the business's management authorities change or adjust the accounting income information reported by the firm in order to maximize the main body's interests using accounting standards. Certain academics feel that earnings management is company managers' "disclosure management" in order to attain some private interests by consciously influencing the

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external financial reporting process [2]. Earnings management can restrain the transmission of negative information to the market to a certain extent, significantly reducing the information transparency. Therefore, when the ability of enterprises to accommodate negative news reaches the limit, a stock price drop is a distinct possibility. There are many means to manipulate profits. In addition, the information asymmetry between managers and investors is common. The actual performance of enterprises is generally difficult to be known by outsiders. Managers are motivated and capable of concealing bad facts, which increases the risk of individual stock crash. This link is exacerbated by poor quality of financial reporting, particularly earnings management and a lack of caution. The lower the chance of a stock price drop, the greater the company's profits quality. At the same time, securities analysts' tracking and institutional investors' shareholding may lessen information imbalance and asymmetry of information earnings management to weaken the negative correlation. Accounting statements are a vital source of information for investors of the company's development and information. The worse their quality, the harder it is to understand the company's real level, and the more likely managers are to control information. The probability of a stock market fall increases when financial reporting information becomes less transparent.

Using data from publicly traded corporations in the United States of America, the empirical results reveal a strong link between the degree of profit management and the potential for the stock crash of price risk. Earnings management is hidden and has always been a favourable tool for managers to manipulate profits. Managers hide or postpone the exposure of negative news by using earnings management. Previous research has discovered a strong link between information opacity and the stock crash of price risk. The larger the probability of a stock price drop, the lower the quality of information [3].

2.2 Financial reporting comparability

Financial reporting for all purposes aims to give consumers enough information to determine the amount, timing, and unpredictability of future net cash flow for a corporation. Financial statement comparability [4], another desired feature of financial reporting has been discovered to reduce crash risk. Not only will investors have a greater grasp of a company's performance, but they will also be able to make more informed decisions by having access to and interpreting information from comparable firms, but they can also learn some of the bad news about it by inferring from similar competitors' performance or disclosures. Even if there isn't any unfavourable news from a specific company, investors may be able to gather some unfavourable information about that company by drawing inferences from the performance or disclosures of the firm's similar peers. When investors have a better grasp of a company's performance, it significantly impacts management’s abilities and motivations to hide unfavourable news.

Although more similar financial information might benefit external stakeholders, in the face of fierce competition, there will very certainly be large proprietary costs of comparison. This occurs when managers create competitive strategies using financial data from their competitors' financial reports as inputs. As a result, executives of companies in competitive industries would be enticed to reduce comparability of financial statements.

The findings show that accounting comparability lessens the likelihood of a crash by allowing outside investors to compare disclosure practices and business performance across firms. Financial statement comparability deters management from concealing negative news and collecting it within a company, lowering investors' estimates of the company's future collapse risk [5].

3. INTERNAL CORPORATE GOVERNANCE

3.1 Independent directors

Managers hide negative news to safeguard their wealth, reputation, and employment when business performance falls short of investors' expectations [6]; [7]; [8]; [9]. Corporate governance rules can assist avoid opportunistic executive conduct and lower the likelihood of a stock market meltdown [10]; [11]; [12]. Typically, a committee of directors is generally considered to play a crucial role in corporate governance. Especially when it comes to monitoring senior management [13].

Independent directors are those who are not affiliated with the business's shareholders, do not have internal positions in the corporation, have no vital commercial or professional interaction with the firm or its management, as well as the ability to make autonomous judgments about the company's operations. As an important component of corporate governance, the independent director system was originally established to alleviate the agency conflict and protect small and medium-sized investors as a third party. At the same time, it can supervise the behaviour of managers. According to some experts, the greater the proportion of independent members on the board of directors, the greater the supervisory influence on management, and the more comprehensive the information voluntarily supplied by the management. Financial decisions should be made in the best interests of all shareholders according to independent directors, not merely the management, controlling shareholders, or minority shareholders [14]. Financial choices should be based on the best interests of all shareholders, according to independent directors [14].

When a small number of persons control a significant corporation, corporate governance becomes critical since profits may be readily managed to favor them at the cost of the public good. As a result, the danger that these manipulations would harm stakeholders necessitates keeping an eye on such managers' opportunistic behaviour. However, some scholars believe that the role of independent directors is not obvious.

According to another paper [15], the audit committee having a substantial number of independent directors, having appropriate auditor sector knowledge, and having a properly defined corporate governance strategy minimizes the risk of a collapse.

3.2 Internal control

Internal control refers to a series of control activities within the company to jointly maintain a series of basic objectives of the enterprise. Internal control has five basic elements. Internal control is an important existence. Internal control, in particular, plays a vital function as the internal system of self-regulation and self-restraint of firm production and operation activities.

Internal control quality is found to be adversely connected to the likelihood of a collision. The findings support the hypothesis that internal control can limit CEO concealment of bad news, lessening the stock crash of price risk. Furthermore, the data imply that not all aspects of internal control are created equal [16]. Crash risk is significantly reduced by the control environment, information and communication, and monitoring components. Components of the risk assessment and control activities, on the other hand, have no influence on the risk of a collision. According to various findings from different components of internal control, the control environment, monitoring, and information and communication are more important in handling negative news than the other five components of internal control. Risk assessment and control aren't as important as they formerly were.

Internal control, according to this research, reduces managers' capacity to keep damaging news hidden, which helps to lower the chance of severe negative events and, as a consequence, crash risk.

4. EXTERNAL MONITORING

4.1 Analysts

Outside block shareholdings (insider ownership) have insignificant (major) influence on collapse risk [15]. The function of financial analysts as a governance tool for creating and distributing company specific information has always been the subject of study. Analysts are more interested with generating industry and market-wide data than with obtaining individualized private data [17].The other researchers propose that counting on the coverage commencement date, the start of analyst coverage has variable implications on price synchronization. Analyst coverage might have two opposed effects on a company's collapse risk. Financial analysts are supposed to reduce information asymmetry between investors and management by disclosing their findings to the markets, which may come from both public and private sources. As analyst coverage grows, more time and resources are devoted to obtaining firm-specific confidential information. Because managers prefer to keep bad news to themselves, this private data collecting and reporting strategy likely reduces information asymmetry more when the organizations have terrible news rather than good news [18]. As a result, this viewpoint argues that having more analyst coverage lessens the chance of a stock price drop.

On the flip side, pressure from the market to reach or exceed analyst expectations develops a culture of management suppressing negative news. Increased analyst coverage attracts greater investor attention and elevates analyst estimates as managers' standards. Increased analyst coverage may therefore put more pressure on executives to focus solely on short-term performance [19, 20], thus resulting in the hoarding of unpleasant news. Factors described above suggest the relationship between changes in the scope of analysts' research and changes in the likelihood of future failures of specific companies.

4.2 Institutional investors

Financial statements are used by institutional investors to evaluate the performance of their investment portfolios and, as a result, to determine asset allocation. As a result, institutional investors rely on the accuracy of numbers in a company's financial report. Institutional investors can understand the operation of the company through the company's financial statements. Indeed, top management decision-making can be influenced by institutional investors, according to the voice [21] and departure [22] theories.

The favourable relationship between POLCON firms and the danger of a stock market fall is mitigated by effective institutional oversight, according to a study of POLCON firms in Malaysia [23]. The effective supervision of institutional investors can alleviate the company's serious agency problems and information opacity. More importantly, recent research suggests that local institutional investors are largely responsible for this successful monitoring.

5. CONCLUSIONS

The empirical research on the causes and effects of stock market crashes is extensive, including the fundamental theory of stock crash of price risk and the

many components that contribute to the stock crash of price risk, was examined in this research. The increasing literature on collapse risk has focused mostly on managerial incentives for storing negative news. The quality of information disclosed is an essential aspect that contributes to the danger of a stock price fall. The stockpiling of unfavourable news caused stock values to plummet and the trading market to become unstable. Listed companies can also affect stock liquidity through the improvement of their governance level and information transparency, so as to reduce the stock crash of price risk.

At present, the research on stock crash of price risk has been very extensive. Scholars have excavated its influencing factors from various angles and proposed the prevention mechanism. This paper believes that future academic research is required from three perspectives. First, relevant research is mostly carried out from the viewpoint of information asymmetry theory and agency theory. The literature on the impact of managers' and investors' behaviour on the stock crash of price risk from the perspective of behavioural finance needs to be enriched in the future. Secondly, most scholars study the elements that influence the possibility of a stock price risk, but there are few social and economic problems caused by the stock crash of price risk. The likelihood of future stock crashes of prices affected by the macro environment, internal, external and management factors. However, whether the stock crash of risk will affect the company's financing cost, risk-taking and investment efficiency, capital structure, decision-making strategy and the appointment and removal of managers remained unclear. Third, the research on relationship direction can be expanded, such as whether the relationship between the company and its suppliers and customers and the relationship with banks and securities companies have an effect on the danger of a stock market crash.

These ideas have the potential to significantly alter our future. The global economy will grow in strength.

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