



Behavioral Analysis of the Capital Market Reaction to Financial Restatements with Emphasis on the Psychological Dimensions of Investors

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Abstract

This study aims to analyze the impact of financial restatements on the stock market reaction and to examine the moderating role of investor sentiment in the Tehran Stock Exchange. Using panel data from listed companies during the period 2014 to 2024 and applying a fixed effects regression model, the findings indicate that financial restatements have a negative and significant effect on cumulative abnormal stock returns. This result is consistent with asymmetric information theory and signaling theory, suggesting that restatements, as a signal of reduced financial reporting quality, diminish investor confidence and lead to stock price declines. Furthermore, investor sentiment plays a significant moderating role; during periods of high sentiment, the market's negative reaction to restatements is intensified. In addition, firm fundamentals (size, profitability, and information transparency) also moderated the market reaction; smaller, less profitable firms with lower transparency experienced a stronger negative reaction, supporting liquidity and firm risk theories. Overall, the results strongly indicate that financial restatements serve as a negative signal, prompting adverse market reactions, and that the intensity of this reaction is significantly influenced by investor sentiment and firm fundamentals.

Keywords: Financial restatements, Stock market reaction, Investor sentiment

JEL Classification: G14; G41; M41; C33.

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INTRODUCTION

Financial restatements often trigger negative market reactions but in emerging markets like Iran—characterized by high retail investor participation, information asymmetry, and pronounced behavioral biases (Wang, 2023), this reaction is significantly influenced by investor sentiment. This study examines how retail investor sentiment and firm fundamentals interact to shape market responses to restatement disclosures in Iran, a relationship less explored in prior literature (Bouteska, 2019). Using a hybrid methodology combining event studies and advanced regression with non-linear analysis, it provides new evidence that high sentiment can amplify and distort reactions (Ahmadi., et al. 2013). The findings contribute to behavioral finance and reporting literature, with practical implications for regulators in enhancing transparency, designing warning systems, and improving investor literacy to stabilize markets (Ghadiryian & Fattahi, 2015).

The primary objective of this study is to examine the effect of financial restatements on stock market reactions, with a particular focus on the moderating role of investor sentiment in the Tehran Stock Exchange. Drawing on the theoretical underpinnings of information asymmetry and signaling theory, the research seeks to elucidate how restatements act as a negative signal concerning the credibility and quality of financial reporting. Such disclosures are expected to undermine investor confidence and trigger unfavorable market responses.

METHODOLOGY

This study employs panel data from firms listed on the Tehran Stock Exchange over the period 2014–2025 (1393–1403 in the Iranian calendar). A fixed-effects regression model is utilized to investigate the association between financial restatements and cumulative abnormal stock returns, while accounting for investor sentiment as a moderating variable. In addition, firm-specific fundamentals—including size, profitability, and the level of informational transparency—are incorporated to explore their interactive effects on market reactions.

RESULTS

Empirical results provide evidence that financial restatements exert a statistically significant and negative effect on cumulative abnormal stock returns, indicating that restatements are perceived as a deterioration in the quality of financial information and lead to downward price adjustments. Investor sentiment amplifies this effect, such that in periods characterized by heightened sentiment, the adverse market reaction becomes more pronounced. Furthermore, the analysis demonstrates that smaller firms, less profitable firms, and those with lower informational transparency experience stronger negative reactions, consistent with liquidity-based explanations and firm-specific risk theories.

CONCLUSION

The findings underscore the role of financial restatements as a credible negative market signal, which substantially influences investor behavior and stock price dynamics. The study highlights the behavioral dimension of capital markets by showing that both psychological factors, such as investor sentiment, and structural firm-level attributes jointly shape the intensity of market responses. These insights carry important implications for regulators, managers, and policymakers, emphasizing the necessity of enhancing the reliability and transparency of financial reporting to mitigate adverse market consequences and strengthen investor trust.

Contribution of Authors

All authors contributed equally to the design, data collection, analysis, and writing of the article. All authors have read and approved the final version of the manuscript.

Ethical Approval

This research was conducted in accordance with ethical principles and standards, and all necessary approvals and consents were obtained prior to the commencement of the study.

Sponsor

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Conflict of Interest

The authors declare that there is no conflict of interest related to the publication of this article.

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