

# The role of firm life cycle in the functioning of capital markets

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# VALORIZATION

According to Appendix 4 of the Regulation Governing the Attainment of Doctoral Degrees (Maastricht University 2013), knowledge valorization refers to the “process of creating value from knowledge, by making knowledge suitable and/or available for social (and/or economic) use and by making knowledge suitable for translation into competitive products, services, processes and new commercial activities” (adapted definition based on the National Valorization Committee 2011:8). Five questions are addressed in this valorization addendum: 1. **Relevance** – What is the social (and/or economic) relevance of the research results (i.e. in addition to the scientific relevance)? 2. **Target groups** – To whom, in addition to the academic community, are the research results of interest and why? 3. **Activities** – Into which concrete services, processes, activities or commercial activities can the results be translated and shaped? 4. **Innovation** – To what degree can the results be called innovative in respect to the existing range of services, processes, activities and commercial activities? 5. **Schedule and Implementation** – How will this/these plan(s) for valorization be shaped? What is the schedule, are there risks involved, what market opportunities are there and what are the costs involved?

1. **Relevance.** Over the past two decades, various developments – including rapid technological innovation, advances in information technology and globalization – have contributed to increased dynamics in capital markets. Hand in hand with these developments we have witnessed a decrease in the relevance of financial information – i.e., the extent to which financial information affects the decisions made by capital market participants. Combining the importance of financial information in the communication between firms and their stakeholders, as underlined by accounting standard-setters, with the limited ability of (current) accounting standards to adequately capture increased dynamics, the social and economic relevance of this dissertation are reflected in its investigation of how firm dynamics affect the behavior of various capital market participants. More specifically, in this dissertation I adopt a dynamic view of the firm – as captured by the firm life cycle – and examine to what extent various capital market participants incorporate and understand a firm’s evolvement over time. Making capital market participants aware of their own and others’ (mis)understanding of firm dynamics can help them to overcome the problems they face in incorporating life cycle information and, hence, to improve their future decisions.<sup>53</sup>
2. **Target groups.** Given the research questions addressed in this dissertation, the findings can inform capital market participants and regulatory bodies in their decision-making and standard setting, respectively. Specifically, the findings in Chapter 2 suggest that

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<sup>53</sup> I do not claim that capital market participants are unaware that firms evolve over time. Yet, it is their understanding of the impact of firm life cycle on the informativeness of financial information that affects the quality of their decisions.

investors' limited understanding of firm life cycle can lead to substantial welfare losses as a consequence of stock price crashes. This finding is relevant for investors, managers and regulators. First of all, it makes investors aware of the costs related to the valuation difficulties of early-stage firms that arise due to the substantial impact of growth opportunities on firm value. As the problems investors face in valuing early-stage firms could also negatively affect firms, for instance in the form of higher costs of capital, managers may want to inform investors better of their current position in the firm life cycle to reduce these potential costs. Furthermore, regulators could put more effort in (further) increasing investors' awareness of the limitations of current accounting standards to mitigate a further decline in the relevance of financial information.

The findings in Chapter 3, which investigates the behavior of financial analysts over the firm life cycle, are relevant for both investors and financial analysts. For investors, the results not only indicate that analysts respond to their varying needs over the firm life cycle but also provide insights in when analyst forecasts are most accurate. For analysts, the findings could increase their awareness of the changes in the earnings generating process that relates to transitions between life cycle stages. Since life cycle changes appear to be followed by a decline in forecast accuracy, financial analysts fail to incorporate these changes in their forecasts immediately. More timely and adequate incorporation of life cycle changes could therefore improve their forecasts.

Finally, Chapter 4 examines how debt markets are affected by firm life cycle. The findings in this chapter are relevant for firms (borrowers) and investors (lenders). Specifically, the findings in Chapter 4 indicate that both public and private lenders incorporate firm life cycle information in the design of debt contracts while taking the varying needs of the borrower into account. Although prior research has found that bond contracts tend to be rather standardized, the implication of the findings in this study for borrowers is that bond contracts still have features that reflect the different needs over the firm life cycle and, hence, provide borrowers with the necessary flexibility. For lenders, the findings in this study inform them about firms' preferred source of lending across life cycle stages and suggest that they are able to incorporate firm dynamics in the debt contract design.

3. **Activities.** As suggested by the preceding paragraphs, different capital market participants can use the insights from this dissertation in their day-to-day activities. By increasing their awareness of how firm life cycle affects the behavior of (and interaction among) capital market participants, the findings in this dissertation can be used, for instance, by (1) investors to make better informed investment decisions; (2) financial analysts to improve their forecasts of future firm performance; (3) lenders when screening potential borrowers and designing debt contracts; (4) firms in the communication with their stakeholders; and (5) regulators in their standard setting.
4. **Innovation.** By excluding firm life cycle from their analyses, previous research in the accounting and finance literature has implicitly treated firms as rather static entities. The increased dynamics in capital markets and firms' business models, however, require the adoption of a more dynamic view of the firm. Under this dynamic view, the firm is treated as an entity that evolves back and forth through multiple stages of development over time. While recent studies have started to examine how firms' (internal) policies differ across

firm life cycle stages, limited research has investigated how the firm life cycle affects the behavior of capital market participants. As such, adopting a dynamic rather than a static view of the firm in this dissertation provides novel and innovative insights in how capital market participants are affected by firm dynamics that can help them to enhance their decision-making processes.

- 5. Schedule and Implementation.** As mentioned before, increasing the awareness of firm life cycle among capital market participants could help them to make better informed decisions in the future and, as a result, could lead to a more efficient allocation of financial resources across the available investment opportunities. While it is relatively easy to derive a firm's current life cycle stage from publicly available financial statements based on Dickinson's (2011) life cycle classification, incorporating firm life cycle information in decision-making and regulation is not without limitations. Specifically, even if capital market participants are aware of the impact of firm life cycle on the relevance of financial information, the forecasting difficulties of firms across the various life cycle stages remains. Nevertheless, whereas the valuation of firms is never without risk, the insights in this dissertation can help capital market participants to better incorporate the risks related to firm dynamics in their analyses. Additionally, managers and regulators can try to further decrease the costs and risks involved in incorporating firm life cycle information by providing or requiring more information on firms' expected development (conditional on their life cycle stage). Yet, despite the managers' superior private information about the company, managers are also not able to perfectly foresee the future. Therefore, before disclosing or requiring additional information on firms' expected development, managers and regulators have to trade-off the benefits of a potential increase in the relevance of the information against the costs related to a potential loss in the reliability of these numbers. Furthermore, it is questionable whether the proprietary costs of information – that are arguably especially high for early-stage firms – offset the potential benefits that can be derived from additional disclosure.

