

# **The Impact of Cost Stickiness on Firm Value: The Moderating Role of Free Cash Flow**

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## **1. Introduction**

In the traditional view, the cost behavior is divided into three categories: fixed, variable and mixed in terms of the change in the amount of cost compared to the change in the activity level. However, over time, it became clear that some costs show asymmetric behavior. This means that the amount of cost reduction when reducing and increasing the level of activity is not equal or symmetrical. The phenomenon of cost stickiness occurs based on managers' decision to maintain slack resources. That is, when the level of activity decreases, the resources that were created at the time of increased demand will be in the role of slack resources. Cost stickiness leads to the decrease and volatility of profitability. Investors use the current year's profit as a key indicator to evaluate the performance of managers, as well as a tool to predict the future profitability and cash flow of companies; any decrease in the sustainability of profitability can increase the the investors' risk, which leads to the firms' value to decrease. Free cash flow affects cost stickiness because this component reinforces the empire-building motivation of managers by increasing the opportunity to create and maintain slack resources. So the high level of free cash flow can increase the level of cost stickiness, and lead to greater reduction in firm value.

## **2. Hypotheses**

In this research, by examining the existing literature and theoretical foundations, two hypotheses have been developed, as follows:

**H1-** Cost stickiness has a negative and significant relationship with company value.

**H2-** Free cash flow intensifies the negative relationship between cost stickiness and company value.

## **3. Method**

Adopting a positivist paradigm and a hypothetical-deductive approach, the study first formulates hypotheses based on existing literature and then uses inductive methods by collecting and analyzing

data for 129 companies accepted in the Tehran Stock Exchange in the period of 2013-2022 to validate these hypotheses. The hypotheses are tested using generalized least squares regression.

#### **4. Result**

The results indicate a negative relationship between cost stickiness and firm value. Specifically, 1 unit increase in cost stickiness decreases firm value by almost 14% in the tested models. Additionally, free cash flow significantly intensifies the negative relationship between cost stickiness and firm value.

#### **5. Discussion and Conclusion**

The primary factor behind cost stickiness is the manager's decision to not adjust slack resources. i) Cost stickiness increases investment risk and reduces firm value by affecting the level, sustainability, and quality of profitability and ii) Free cash flow exacerbates this negative effect by enabling managers to maintain slack resources. The findings confirm that cost stickiness reduces firm value and that free cash flow exacerbates this relationship.

**Keywords:** Cost Stickiness, Slack Resource, Investment Risk, Firm Value, Free Cash Flow.