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Market Reaction to Asymmetric Cost Behavior: The Impact of Long-Term Growth Expectations[1]

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Research Paper

INTRODUCTION

The traditional view of cost behavior separates costs into fixed and variable. It does so based on their response to changes in a firm's activity level. Fixed costs are constant. Variable costs change with the activity level (Noreen 1991). However, empirical evidence shows that the cost behavior is asymmetric. In accounting, Anderson, Banker, and Janakiraman (2003) found early proof of asymmetric cost behavior. They show that the relation between cost and activity level depends on the direction of activity changes. Selling, general, and administrative costs increase by 0.55% for a 1% growth in sales, but decrease by only 0.35% for a 1% drop in sales.

Demand fluctuations and growth expectations affect production resources and costs. Research shows that, in high-growth companies, the drivers of asymmetric cost behavior differ from those in low-growth firms. It also shows that the capital market reacts differently to asymmetric cost behavior. (Silge and Wöhrmann, 2021). Long-term growth expectations refer to a business's expected activity and profits. High expectations mean the company's sales, profits, and investments will rise (Dickinson, 2011). Asymmetric cost behavior likely comes from different drivers. Firms with high growth expectations should show more of it. They are more likely to re-increase sales after a sales decline. It has low long-term growth expectations. Some argue that, despite hopes for long-term growth, the capital market reacts negatively to unexpected costs. Investors see

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asymmetric cost behavior as a signal of agency incentives or high adjustment costs. This lowers the firm's value (Banker, Byzalov & Plehn-Dujowich, 2014; Chen, Lu, & Sougiannis, 2012). So, if a firm has low long-term growth, the capital market will react more negatively to unexpected asymmetric cost behavior. On the other hand, long-term growth expectations are important as a main driver for the unexpected cost asymmetric behavior. For example, in times of low demand, management is more sensitive to holding resources. This occurs when long-term growth expectations are low, thus holding fewer resources. The unexpected cost behavior in firms with high growth expectations is likely due to rational resource planning. In contrast, firms with low growth expectations are more likely to have agency problems (Silge and Wöhrmann, 2021).

The current research predicts that asymmetric cost behavior depends on long-term growth prospects. Investors' views and the market's response differ for high- and low-growth companies. This study contributes to the stream of research on cost asymmetric behavior in several respects. First, the research adds to the literature. It shows that a firm's long-term growth expectations lead to cost asymmetric behavior. Second, the research develops the measurement criteria used in this field. These include gross domestic product and sales trends. Third, the asymmetric cost behavior affects the company's value. So, the capital market's reaction is important. This study adds to the literature. It argues that investors do not behave the same toward all types of companies with asymmetric, unexpected cost behavior.

This study adds to the literature on management accounting and capital markets. It documents the capital market's reaction to asymmetric cost behavior. It also links cost behavior, a key area of management accounting, to investors' actions in the capital market.

HYPOTHESES

Differences in long-term growth expectations can affect the expected cost of unused capacity and thus asymmetric cost behavior. Depending on whether firms have high or low long-term growth expectations, there are different predictions for the level of asymmetric cost behavior. Companies with high long-term growth opportunities expect a significant increase in sales (Churchill and Lewis, 1983; Flamholtz and Randle, 2007) and therefore continue to make major investments (Spence, 1979). These expectations make managers less willing to reduce resources during temporary sales declines because they intend to avoid adjustment costs when activity increases. In contrast, companies with low long-term growth expectations suffer from saturated markets and reduced growth rates, which will lead to reduced value and prices (Miller and Friesen 1984; Wernerfelt, 1985). Therefore, managers have lower long-term and short-

term positive expectations and are more likely to reduce resources than increase them (Dickinson, 2011). Therefore, managers of companies with low long-term growth expectations are more inclined to reduce resources in the presence of short-term signals of declining sales. In general, in companies with high long-term growth expectations compared to companies with low growth opportunities, economic reasons cause asymmetric cost behavior of a more sticky type. Therefore, it is expected that the degree of asymmetric behavior of the cost stickiness type is higher in companies with high long-term growth expectations, and the first hypothesis of the research is formulated as follows:

H1: *In companies with high long-term growth expectations, the degree of cost stickiness is higher than in companies with low long-term growth expectations.*

Anderson et al. (2007) argue that increases in the ratio of general, administrative, and selling expenses during periods of declining sales are positively related to future revenues. Therefore, unexpected cost stickiness should lead to a positive investor reaction due to the presence of a signal of higher future profits. Weiss (2010) found that the degree of cost stickiness affects earnings predictability and thus investor behavior, which leads to a weaker market reaction to earnings surprises for firms with more sticky costs. He argues that cost behavior is relevant to forming investors' beliefs regarding firm value. Esmailzadeh and Mehrnoosh (2014) showed that the accuracy of earnings forecasts decreases with the increase in cost stickiness. Therefore, market participants initially interpret the sticky behavior of the cost as evidence of a negative reaction. There are more reasons to expect a negative reaction than a positive capital market reaction to this kind of unexpected cost behavior. First, agency factors and an incomplete understanding of the sticky behavior of the capital market lead to a negative reaction to the capital market. Second, from an economic point of view, unexpectedly high adjustment costs lead to a negative market reaction, and unexpected future sales can lead to a positive relationship between the unexpected sticky behavior of the cost and the capital market reaction. Considering the above arguments and empirical evidence, it is expected that the market's evaluation of the unexpected cost stickiness will be negative. Therefore, the second hypothesis is formulated as follows:

H2: *Capital market reaction to unexpected cost stickiness is negative*.

Investors' assessment of the asymmetric behavior of unexpected costs depends on the probabilities they attribute to economic drivers versus

agency. Silge and Wöhrmann (2021) found that in companies with high long-term growth expectations, investors are more likely to attribute economic reasons. Therefore, the market evaluation of companies with low long-term growth expectations is more negative. Chen et al. (2012) found that agency issues, such as empire building, are less common in growth firms than in non-growth firms. Therefore, investors are more likely to attribute agency reasons to companies with low long-term growth expectations. In sum, if companies have the same level of unexpected cost stickiness in periods with high long-term growth expectations as well as in periods with low long-term growth expectations, negative market reaction to unexpected cost stickiness is expected in periods with high long-term growth expectations be less. Therefore, the third hypothesis is formulated as follows:

H3: *In companies with high long-term growth expectations, compared to companies with low long-term growth expectations, the negative reaction of the capital market to unexpected cost stickiness is less.*

METHOD

The current research is applied and descriptive-correlational in terms of purpose and method, respectively. The statistical population of the research includes all the companies accepted in the Tehran Stock Exchange in the period from 2015 to 2021. To select a sample that represents the statistical population, companies with the following conditions were selected: (1) their financial year ends at the end of March and they have not changed their time during the research period. 2) the data related to the research variables are available and their shares have been traded in the years under review and (3) they are not among banks and financial intermediaries, investment companies, and holding companies. Considering these conditions, 155 companies (1085 observations) were selected. Data was collected using Rahardnovin software and the Codal Website. Multiple regression models were used for data analysis and hypothesis testing.

RESULTS AND DISCUSSION

Consistent with our first prediction, results indicate that companies with high long-term growth expectations versus low long-term growth expectations have higher levels of cost stickiness. Concerning our second hypothesis, we find evidence that the capital market assessment of SG&A cost stickiness is negative on average. That is, investors react more negatively to earnings announcements from companies with unexpected sticky costs. In line with the third hypothesis, we confirm that capital market reaction to cost stickiness is less negative for companies with high

long-term growth expectations. The result of this research is consistent with the findings of Esmaeilzadeh and Mehrnoosh (2014), Silge and Wöhrmann (2021), and Anderson et al (2007).

CONCLUSION

This research aims to study the capital market's response to asymmetric cost behavior. It focuses on long-term growth expectations. The research found that, in firms with high growth hopes, cost stickiness is greater than in those with low hopes. This finding means that, in high-growth companies, if sales fall, the chance of a sales rebound is higher than in low-growth firms. This affects cost behavior. In addition, the findings indicate that the capital market reacts negatively to unexpected cost stickiness. In this regard, Anderson et al. (2007) argued that market participants' expectations align with their evaluation. This is based on the conventional model of cost behavior, not asymmetric cost behavior. Therefore, market participants are expected to interpret cost stickiness as evidence of weak cost control and react negatively. Also, Silge and Wöhrmann (2021) showed that investors view asymmetric cost behavior as a signal. It suggests agency incentives or high adjustment costs. This leads to a drop in the company's value and a negative market reaction.

Finally, the findings show that the capital market's negative reaction is affected by long-term growth expectations. Investors are less upset by unexpectedly high costs in firms with high growth expectations than in those with low ones. These findings mean that, in companies with high growth expectations, it is less likely that unexpected cost stickiness is due to agency motives. Instead, it shows managers' rational resource planning. This should increase the company's value and reduce negative market reactions.

Managers' decisions on using the company's resources depend on many factors. These include both internal and external ones. Therefore, capital market participants should pay attention to the fact that in different situations, managers' decisions regarding resource adjustment and its impact on cost behavior can be different. Investors, analysts, and other users should note the company's long-term growth expectations in their analyses and forecasts. Also, managers should watch the capital market's reaction when adjusting resources.

According to these findings, managers' economic motives are one of the main drivers of asymmetric cost behavior. Firms that expect higher future growth rates tend to reduce the risk of idle capacity by increasing investment. Investors also revise their evaluations in case of an increase in unexpected cost stickiness.

The research raises new issues and factors. Some cannot be examined due to limitations. This research assumes that economic motives cause

asymmetric cost behavior. So, future research should study the market evaluation of other drivers of asymmetric cost behavior. As an example, if the asymmetric behavior of the unexpected cost is caused by managerial motives, how will the capital market's reaction be?

Keywords: Asymmetric Cost Behavior, Long-term Growth Expectations, Market Reaction, Unexpected Cost stickiness.
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