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Earnings management, corporate governance and expense stickiness

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ABSTRACT

Cost and expense stickiness is an important issue in accounting and economics research, and the literature has shown that cost stickiness cannot be separated from managers' motivations. In this paper, we examine the effects that earnings management has on expense stickiness. Defining small positive profits or small earnings increases as earnings management, we observe significant expense stickiness in the non-earnings-management sub-sample, compared with the earnings-management sub-sample. When we divide expenses into R&D, advertising and other general expenses, we find that managers control expenses mainly by decreasing general expenses. We further examine corporate governance's effect on expense stickiness. Using factor analysis, we extract eight main factors and find that good corporate governance reduces expense stickiness. Finally, we investigate the interaction effects of earnings management and corporate governance on expense stickiness. The empirical results show that good corporate governance can further reduce cost stickiness, although its effect is not as strong as that of earnings management.

1. Introduction

The term expense "stickiness" captures an asymmetric expense behavior response to the direction of a change in activities; that is, expenses increase more quickly with an increasing activity level than they decease with a declining activity level (e.g., Noreen and Soderstrom, (1997), Cooper and Kaplan (1998), and Anderson et al. (2003)). Because it is an important issue in both accounting and economic researches, expense stickiness, to some degree, reflects the operating efficiency of corporate assets (Gong et al. (2010)).

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Compared with the classic linear cost behavior model described by traditional management accounting, expense stickiness fits better with the management decision of resource adjustment in practice. The existence of expense stickiness is strongly connected to management's active behavior (e.g., Anderson et al. (2003) and Banker et al. (2011)). Thus, to truly understand stickiness, it is essential to investigate the reasons why management deliberately adjusts resources.

Most previous studies have investigated expense stickiness based on either adjustment costs or management expectations. Some have suggested that the adjustment cost of reducing input under declining activities is higher than that of raising input under increasing activities (e.g., Jaramillo et al. (1993), Pfann and Palm (1993, 1997), Goux et al. (2001), and Cooper and Haltiwanger (2006)). This, in turn, makes it less likely to reduce the input level (i.e., stickiness) because it is more expensive to do so. Other scholars have suggested that managers tend to be optimistic about future revenue because most firms' future revenues increase, making them reluctant to reduce expenses.

When considering the wide-spread nature of agency problems in modern enterprises (Jensen and Mecking, 1976), it is unlikely that management would behave as expected in an ideal world (i.e., adjustment cost and expectation considerations). There are conflicts between self-interested managers and other stakeholders, of which earnings management behavior under compensation contracts is the most obvious. Healy (1985) found that managers adjust earnings in order to receive higher compensation. While under pressure to avoid breaching debt covenants, managers are also likely to choose between accounting policies (Sweeney (1994)). Moreover, previous studies have indicated an increase in earnings management due to the incentives of meeting or beating last year's earnings, avoiding reporting losses, and meeting or beating consensus analysts' forecasts (e.g., Burgstahler and Dichev (1997) and Degeorge (1999)).

In the earnings management literature, few studies have explored earnings management's effect on expense stickiness. Chen (2008) investigated the relationship between managerial empire building and expense stickiness. Dierynck and Renders (2009) observed the stickiness of labor costs in firms that reported small positive ROAs and slightly increased earnings. Kama and Weiss (2010) provided evidence that firms reduced the stickiness of operating costs to avoid losses or earnings decreases. Compared with the cost of sales, expense is a different type of cost. In this paper, we shed light on the relationship between expense stickiness and earnings management incentives.

We begin by investigating earnings management's effect on expense stickiness. We define the incentive to avoid losses or earnings decreases as upward earnings management, and divide the sample into two parts. Significant expense stickiness is observed in the non-earnings-management sample, compared with the earnings-management sample, indicating that managers, under pressure to report sound earnings, prefer to reduce expenses when sales decline.

Whether expense reduction indicates increased operating efficiency or short-sighted and dysfunctional managerial behavior remains an interesting question. To answer this question, we further divide expenses into R&D, advertising, and other general expenses.[1] The results show that the stickiness reduction difference between the earnings-management and non-earnings-management sub-samples is much more significant in other general expenses than in R&D or advertising expenses. Facing the pressure of upward earnings management makes managers more likely to reduce expenses in a discriminate way for their firms' long-term development.

Next, we analyze what influence corporate governance has over expense stickiness. Taken as an essential part of the management operation environment, corporate governance studies have generated conflicting evidence. Some attribute the chaos to the difficulty of setting up a reliable and effective evaluation system on corporate governance. Drawing from the work of Larcker et al. (2007), we choose the method of factor analysis to produce a comprehensive and objective description of corporate governance. After extracting eight main factors from the summarized corporate governance indices, we find that good corporate governance has a negative effect on expense stickiness.

Then, we check the interaction effect of earnings management and corporate governance. Our results show that the interaction works to further reduce expense stickiness, indicating that self-interest upward earnings

[1] We appreciate the helpful comments of the referee.