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Managerial discretion and agency cost in Indian market

Chakkappanthodiyil Namitha [a,1], Santhakumar Shijin [b,2]

[a] Department of Commerce, School of Management, Pondicherry University, Pondicherry 605014, India
[b] Department of Commerce, School of Management, Pondicherry University, Pondicherry 605014, India

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A B S T R A C T

This paper investigates empirically the impact of managerial discretion on agency cost from the perspective of SG&A cost asymmetry and examines how corporate governance moderates this relationship. The analysis shows mixed evidence in favor for cost behavior and managerial choices in the Indian market. The cost asymmetry involves not only cost stickiness but also the anti-sticky behavior of SG&A cost under certain circumstances. The main drivers for this disparity are owing to manager's resource adjustment decision, the future expectation of sales and managers' empire-building behavior. Furthermore, findings suggest that strong corporate governance alleviates empire-building behavior of managers. Additional analysis shows, the asymmetric behavior of SG&A cost in crisis period is mainly a result of managers' resource adjustment decision and future expectation of sales change. Manager's empire-building behavior does not play an explicit role in this period. Next, the findings show that managers' discretion is influenced by future value creation potential of SG&A cost. Manager's empire-building behavior is more pronounced in low-value creation sample firms compared to high-value creation sample. Thus, manager's choice for resource adjustment decision and empire-building behavior changes according to the future value creation of SG&A cost, financial conditions and corporate governance mechanisms in Indian companies. To the best of our knowledge, this is the first study performed in Indian capital market where the SG&A cost asymmetry tests the managers' empire-building behavior. Overall, findings of the study indicate manager's resource adjustment decisions and empire-building behavior caused by their consideration and this results in a form of agency costs. In comparison with developed markets, Indian markets have relatively less agency problem due to managerial empire-building behavior.

1. Introduction

The increasing proportions of multinational enterprises are widely conjectured as managerial desires for welfare rather than the enhancement of shareholder value. This conflict of interests concerning shareholders and managers termed as agency cost is an intensifying disquiet pertinent to contemporary scenario. As opined by Jensen and Meckling (1976), if both parties in the relationship are utility maximizers, there is a probable chance to believe that the agent will not act in the best interest of the shareholders. This utility maximization as stated by Stulz (1990) can be in the form of empire building behavior, the consumption of corporate resource perquisites, the avoidance of optimal risk investment and manipulating financial figures to increase compensation structure. Restraint on this behavior often comes with a cost in the form of monitoring and bonding cost. For instance Murphy (1985) highlighted that agency costs contribute a significant portion of firm's expenses when the focus on earnings based incentives is to increase the value of the firm. The further relationship between firm performances, as measured by shareholders' return, is positively related to managerial incentives. Similarly, the findings of Jensen and Murphy (1990), argue that CEOs' total compensation changes according to changes in shareholders' wealth.

With the separation of ownership and control, executive power significantly affects the design of compensation in companies as evidenced by Bebchuk and Fried (2003). In particular, the incentive problem arises, when decision making in a firm is the province of managers who are not the firm's shareholders. Managers always try to expand the business beyond the optimal level to provide opportunities for managerial satisfaction. On the other hand, the expansion of staff and expansion of physical plant and equipment are possible only when the company has sufficient profit (Williamson, 1963). The enlargement of staff expense and increase in executive compensation will naturally reflect in SG&A cost (Selling, General and Administrative), which is ought to rise for the duration of good times and decline during bad times. SG&A cost serves as a proxy to capture agency induced managerial expenses as a measure of agency cost. The ratio of SG&A expense to total assets is almost 27% in developed economies and 15% in emerging economies like India. SG&A cost comprises the greatest portion of the overhead cost in company's accounting income statement, including advertising and payroll costs, salaries, commissions and cost related to

E-mail addresses: namitha87.c@gmail.com (C. Namitha), shijin.s@gmail.com (S. Shijin).
[1] Tel.: +91 7 598 383 695.
[2] Tel.: +91 9 345 949 434.

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travel for the company's salespeople. Our fundamental accounting assumption is that cost should move proportionately with activity. Prior empirical studies of Noreen (1991) and Noreen and Soderstrom (1997) argue that all costs change proportional to change in activity. However, recent research studies of Anderson, Banker, and Janakiraman (2003), Chen, Lu, and Sougiannis (2012) find that SG&A cost behaves asymmetrically, explicitly, it increases more for increases in sales than they decrease when demand decreases. They report cost should not move mechanically with changes in activity, which are determined by the managers' resource adjustment decision. For instance, empirical evidence by Chen et al. (2012), finds that empire-building managers' increase SG&A cost at a fast pace when sales upsurge and decrease too slowly when sales shrink with the intention of increasing their compensation, power, and status. Self-serving managers constantly try to upsurge office payroll and expenditures often by increasing SG&A expense. Similarly, they delay the cutting of office payroll and expenses when sales downturn.

This movement of SG&A cost leads to cost stickiness and increase agency cost to the firm. Anderson et al. (2003), and Balakrishnan and Gruca (2008), attribute the fundamental cause of sticky costs is the resource adjustment decisions of managers when they try to maximize their welfare instead of a shareholder. The managerial downsizing literature of Hicks (1935) and Bertranad and Mullainathan (2003) indicates that the average managers do not try to increase the firm size, they avoid generating new plants and distracting old ones. Managers always prefer normal life and try to resist challenging decisions and expensive efforts allied with downsizing. The average manager might be characterized by quite life model than by empire building model. The downsizing literature, however, focuses more on the components of SG&A like headcount in companies where SG&A cost represents slack resources channeled into overhead and staff expenses.

Both empire-building and the downsizing, shift agency cost from its optimal level. In the case of asymmetric adjustment cost, managers are more to be expected to postpone downward adjustment in response to an adverse demand shock. The downward adjustment cost increases with agency problem, especially because self-servicing managers are reluctant to scale down committed resources linked to their personal benefits. Especially mangers are less likely to reduce discretionary SG&A spending at times of declines if they must give up their private benefits from such expenditure. Prior studies ignored the effects of managerial incentives on SG&A cost behavior. Chen et al. (2012), try to find, the association between SG&A cost asymmetry and agency problem in developed market and the study argues that sticky behavior of SG&A cost is positively associated with managerial empire-building behavior and negatively related to strong corporate governance efficiency. Kama and Weiss (2013), show that incentives to meet earning targets induce managers to expedite downward adjustment of slack resources, for sales decrease leads to anti-sticky behavior of SG&A cost. This result in agency cost to the firm because these decisions maximize managers' wealth, not firm value. Similarly, findings of Balakrishnan, Petersen, and Soderstrom (2004) develop arguments that costs are likely to be anti-sticky when current capacity utilization is low. The study of Banker, Chen, and Robinson (2006), shows that the type of incentive contract will be affecting empire-building behavior of managers. An efficient compensation contract will motivate the managers in reducing unproductive parts of current spending and motivate them to invest in activities that create good future value.

Most of the empirical studies on cost asymmetry and related agency problem have been in developed countries. These do not apply to India, where underdeveloped capital markets exist with the less active takeover and greater dependence on external debt as a source of finance. Lack of standardized accounting measure, less transparency in financial reporting and the governing systems and enforcement are different from the developed market (Ghosh, 2003; Sarkar & Sarkar, 2000). Managerial markets are not well developed in emerging economies due to the intervention of founder family members. Particularly, in India, most of the enterprises are family owned, and a large number of board members are associated with the founder of the firm (Ghosh, 2006; Fagernas, 2006). Chakraborty (2010) argues that family controls each firm in a business group, and the agency problems between shareholders and managers are not severe in Indian corporates. Hence, there is a chance that a different kind of agency problem between owners and minority shareholders occurs. Hence, after the economic liberalization in 1991 family business groups in India recognized the need for professional managers to compete for Indian business with global markets (Kumar, 2009; Sinha, 2010). Consequently, this results in a rising trend in average compensation of Indian CEO. Subsequently variable pay and stock option are introduced to motivate CEO of Indian firms. On the contrary, Jain, Shveta, and Surendra (2013) found that 78.27% of Indian companies have no incentive plans to motivate senior managers to work towards an increase in corporate value and CEO and managing director hold less than 10% of equity only.

Chakrabarti et al. (2011) argue that without implementing fully, the current tools in executive compensation policy results in an inefficient compensation contract in Indian companies. Sanan and Yadav (2011) find an increase in corporate governance regulations after liberalization, yet the overall enforcement of the Indian corporations was only moderate. The above discussion motivates us to conduct the present study on a similar line and to test in the context of developing markets like India where weak corporate governance and in effective incentive contract for CEO exist. The real intention behind this study is worth exploring since studies have not tested the behavior of SG&A cost asymmetry in Indian firms and the relationship between these cost asymmetry and agency cost. Furthermore, the study tries to examine whether corporate governance mechanism in India is sufficient to moderate the managerial discretion associated with agency problem.

2. Hypothesis development

In the present study, we try to test the hypothesis established by Chen et al. (2012) pertaining to the asymmetrical behavior of SG&A cost and the anti-sticky behavior in the Indian market. In other words, the study tries to test whether SG&A cost increases more when demand upsurges than they decrease when demand diminutions or if they escalate to a reduced magnitude of a 1% increase in sales revenue than they wane for a 1% decrease in sales revenue (Kama & Weiss, 2013). Based on these conjectures the following hypothesis is framed.

H1. SG&A cost behaves asymmetrically in response to an upsurge or shrinkage in sales revenue.

Manager's anticipation about future plays a crucial role in SG&A cost asymmetry, and the permanence of a demand reduction is likely to get stronger with the continuous decline in revenue. Managers are more likely to believe that sales revenue decline tends to be more permanent when it arises in a two consecutive period and will motivate managers to hasten SG&A cost, resulting in less stickiness or anti-stickiness leading to the second hypothesis.

H2. Stickiness of SG&A cost is less pronounced when there is an adverse demand shock in two successive years.

The firm with high employee intensity causes higher adjustment cost, because the firm uses more employees to support its sales revenue. For the duration of the drop in revenue, employees are more costly for the reason that employers must pay severance cost. An upsurge in demand forces them to hire new employees while imparting excess training costs as opined by Anderson et al. (2003), Chen et al. (2012), and Banker, Huang, and Natarajan (2011). The managers are reluctant to scale down resources during demand shrinkages indicating SG&A cost stickiness and anti-stickiness if they are ready to cut back SG&A cost when sales decline, based on which the following hypothesis is framed.

H3. Firm's employee intensity is positively associated with the degree of SG&A cost asymmetry.

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