"The Effect of Agency Theory upon Cost Stickiness"

Extracted from a Master Thesis Titled:

"The integration between sticky cost and Capability Maturity Model Integration (CMMI) supporting continuous improvement in the industrial sector in the context of internal agents- an applied study"

Prepared by
Hagar Ahmed Fouad Abdeltawab
Demonstrator in Accounting Department
Under the Supervision of:
Prof. Mohamed Moustafa El Gibaly
Professor of Cost Accounting, Faculty of Commerce, Beni-Suef University
Dr. Ahmed Mokhtar Abdelsalheen
Lecturer of Accounting, Faculty of Commerce, Beni-Suef University

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Abstract:

The main purpose of the research was to examine the effect of agency problem on cost stickiness, the results revealed that cost exhibits an asymmetric behavior which contradicts the traditional cost assumption, further, agency theory plays a vital role in determining the asymmetric cost behavior through two drivers; empire building incentives that make managers increasing the acquisition of resources when demand increases and keeping unused resources when demand drops in order to chaise their personal benefits resulting in cost stickiness, also, earnings management incentives that make managers delaying the acquisition of needed resources when demand increases and cutting unused resources aggressively when demand declines in order to meet earnings target resulting in a lower degree of cost stickiness.

Key words: Cost stickiness, Asymmetric cost behavior, Agency theory, Empire building, Earnings management.

ملخص البحث:

هدف هذا البحث إلى دراسة تأثير نظرية الوكالة على لزوجة التكلفة، توصلت النتائج إلى أن التكلفة تظهر سلوكاً غير متماثل مما يتعارض مع الافتراض التقليدي لسلوك التكلفة، كما تلعب نظرية الوكالة دوراً حيوياً في تحديد سلوك التكلفة غير المتماثل من خلال محركين وهما دوافع بناء الإمبراطورية حيث يميل المديرين إلى زيادة اقتناء الموارد عند زيادة الطلب والاحتفاظ بالموارد غير المستخدمة عند انخفاض الطلب من أجل تحقيق منافعهم الشخصية مما يؤدي إلى زيادة درجة لزوجة التكلفة، وكذلك دوافع إدارة الأرباح حيث يميل المديرين إلى تأجيل اقتناء الموارد عند ارتفاع الطلب والتخلص من الموارد غير المستخدمة عند انخفاض الطلب من أجل تحقيق الأرباح مما يؤدي إلى انخفاض درجة لزوجة التكلفة.

الكلمات المفتاحية: لزوجة التكلفة, السلوك الغير متماثل للتكلفة, مشكلة الوكالة، بناء الإمبراطورية، إدارة الأرباح.

1- Introduction:

Understanding cost behavior, that is, the way in which the firm's cost structure is influenced by changes in its business activity, is a crucial and vital issue in cost accounting and management accounting because it excessively influences the decision making process **(Abudy and Shust, 2019)**. In traditional assumption of cost behavior, costs are categorized as fixed and variable costs according to their reactions to activity volume changes (changes in the level of activity is usually measured by sales revenue) as variable costs are assumed to change symmetrically or proportionately with activity level changes, while fixed costs remain the same irrespective of activity change within the relevant range, therefore, costs change symmetrically with changes in activity level which called symmetric cost behavior **(Özkaya, 2020)**. For instance, under this traditional assumption the increase (or decrease) in activity volume by 1% results in an equivalent increase (or decrease) by a certain percentage (0.7% or more or less) in costs, here there is an implicit assumption that the magnitude of cost change depends only upon the occurrence of activity volume change and doesn't depend upon the upward or downward direction of activity volume change **(Anderson et al., 2003)**.

However, some studies argued that the traditional assumption of cost behavior is not always valid, and the association between costs and activity is not always linear, these studies showed that costs may exhibit asymmetric behavior; that is, costs may react differently to the equivalent activity change. The modern era in this research field started with the pioneering study of **Anderson, Banker, and Janakiraman, 2003 (hereinafter referred to as ABJ, 2003)** who found that Selling, General and Administration **(SG&A)** costs increase by 0.55% while they decline only by 0.35% for 1% upward and downward change in sales revenue, which implies that costs behave asymmetrically, moreover, they are considered the first to provide an explanation for the asymmetric cost behavior and the first to label these costs as sticky costs, further they defined sticky costs by those costs that increase more than they decrease for the equivalent change in the level of activity.

2- Research problem:

ABJ, 2003 attributed the occurrence of cost stickiness to two essential factors, the first factor is the deliberate decisions of management concerning cutting slack resources when there is an expected drop for its products instead of bearing adjustment costs for slack resources, adjustment costs mean the costs of cutting slack resources when there is an expected demand decline and then restoring, therefore, the firm's management deliberately keeps these unused resources and bears holding costs until demand recovers, while the second factor is the management's personal considerations concerning agency problem that results in agency costs which means that costs don't change symmetrically with the change in activity volume, but are influenced by the deliberate decisions of self-interested managers.

Therefore, the agency problem and the conflict of interests between managers (agents) and shareholders (principals) due to the separation of ownership and control, can be considered an important driver of cost stickiness, when there is an expected demand increase, self-interested managers seek to achieve their personal interests by acquiring resources excessively, thus, when an actual increase in sales revenue occurs by 1%, costs increase by a certain percentage, in contrast, when there is an expected demand decrease, managers prefer to retain unused resources and bearing holding costs instead of adjustment costs by cutting slack resources and restoring them again, managers behave opportunistically in order to avoid personal consequences of downsizing such as loss of status, power or compensation, and thus when an actual decrease in sales revenue occurs by 1%, costs will not decrease by the same percentage of its increase, and thus the percentage of cost increase is different from the percentage of its decrease, contributing to the cost stickiness phenomenon **(Zhang, 2016, and Mohammed, 2019)**. In this regard, agency theory predicts that this opportunistic behavior will happen if not constrained by corporate governance, furthermore the influence of agency problem on cost stickiness can be alleviated by good corporate governance **(Chen et al., 2014)**.

In light of the above discussion, the researcher can conclude research problem in the following questions:

- What is meant by cost stickiness?
- What are the agency drivers of cost stickiness?
- Is cost stickiness positively related with the agency problem?

3- Literature Review:

1- (Özkaya, 2020)

This study provided evidence on cost stickiness from small and medium sized firms in Turkey from 2013 to 2017, the results indicated that; total costs, Cost Of Goods Sold (COGS) and Selling, General and Administrative (SG&A) costs are sticky to different degrees, the cost stickiness degree for all cost types is positively associated with asset intensity and employee intensity while the cost stickiness degree for total costs and COGS is negatively associated with debt intensity, the cost stickiness degree is greater in case of small revenue decreases than in case of larger revenue decreases, and firms have different cost behaviors across different industries.

2- (Chen et al., 2019)

This study investigated the impact of managerial expectations on asymmetric cost behavior in the context of costs of resource adjustment and slack resource constraints, the results indicated that the incremental effect of managerial expectations upon cost asymmetry is the strongest when slack resources and adjustment costs are high, on the contrary, when both of them are low, expectations don't have an effect upon the cost asymmetry degree, in addition, when the degree of slack resources is high, managerial pessimism is related to anti-sticky cost behavior, however, managerial optimism opposites this relation and leads to sticky cost behavior, furthermore, the results showed that the strongest cost stickiness occurs in the following conditions: a low degree of unutilized resources, a high degree of adjustment costs, and optimistic managerial expectations; conversely, the strongest cost anti-stickiness happens when all three drivers work in the reverse direction.

3- (Chung et al., 2019)

This study investigated the effect of institutional monitoring upon cost stickiness, the findings revealed that long-term institutional investors are related to a lower degree of cost stickiness resulting in superior future market and accounting performance.

4- (Hur et al., 2019)

This study aimed to investigate the effect of a Chief Executive Officer's (CEO) confidence level on decisions concerning Research and Development (R&D) expenditures, since R&D is an important part of a firm's strategy in order to achieve sustainable growth in long-term and due to its discretionary nature that makes some CEOs choose to cut R&D costs in order to enhance short term performance, the results indicated that CEO characteristics especially managerial overconfidence has a vital role in determining the behavior of R&D costs as highly overconfident CEOs prefer not to take actions in order to cut R&D costs even if sales drop because CEO overconfidence tends to be positively associated with R&D.

5- (Lee et al., 2019)

This study examined the impact of co-CEO structure on the asymmetric cost behavior because cost behavior because cost behavior reflects decisions of managers about resources that can be influenced by self-motivated incentives such as managers' decisions regarding unused resources when sales drop in order to achieve their personal incentives for empire building and their disincentives to downsize resulting in asymmetric cost behavior, the results showed that the cost stickiness degree is higher in the single-CEO structure than the co-CEO structure, the co-CEO structure works as an external alternative mechanism of corporate governance in order to manage the agency problem through including mutual monitoring among co-CEOs and the cost stickiness degree is lower for firms with higher foreign ownership.

6- (Mohammed, 2019)

This study examined the effect of agency problem and the firm's strategic position on the stickiness of COGS and operating costs in industrial firms listed on the Egyptian Stock Exchange from 2006 to 2017, the findings showed that COGS and operating costs exhibit an anti-sticky behavior, the stickiness of COGS and operating costs is positively associated with the agency problem, furthermore, compared to the strategy of cost leadership, it is found that differentiation strategy better enhances the positive association between the stickiness of COGS and operating costs and the agency problem.

7- (Soenjoto and Alfiandri, 2019)

This study examined the asymmetric cost behavior for both SG&A costs and COGS in Indonesian listed manufacturing firms from 2011 to 2015, the findings showed that it can't prove the stickiness of SG&A costs in overall, while, COGS exhibits an anti-sticky cost behavior, further, asset intensity has no significant impact towards the cost stickiness degree.

8- (Ibrahim, 2018)

This study aimed to provide additional evidence upon asymmetric cost behavior for COGS and empirical evidence concerning the potential influence of corporate governance upon the asymmetric cost behavior in Egyptian registered firms from 2008 to 2013, the results indicated that COGS behaves sticky, further, firms with larger boards, role duality and higher non-executives ratio show higher cost asymmetry than others, whereas, firms with successive sales decrease, greater economic growth and institutional ownership show a lower degree of cost stickiness.

9- (Zhang, 2016)

This study investigated the relationship between the cost stickiness phenomenon and the agency problem, and determined the moderating influence of competition intensity upon this relationship, in North America from 2005 to 2014, the findings revealed that SG&A costs are sticky on average and the agency problem is positively related with SG&A stickiness, further, considered as the supplement of corporate governance, low level of competition strengthens the effect of agency problem upon SG&A stickiness, while, high level of competition does not weaken the effect of agency problems on SG&A stickiness, implying that competition intensity has an external and indirect impact on agency problem and corporate governance still matters in case of high level of competition.

From analyzing previous studies the researcher can conclude that:

1- cost asymmetry has been documented whether cost stickiness or cost anti-stickiness for different cost types including COGS, SG&A, operating costs, and R&D costs.
2- Cost stickiness has been documented at the level of the firm as a whole in all its divisions of various sizes: large, medium and small alike and at the level of different countries, Egypt, Turkey, China, Indonesia, the United States and others, the cost stickiness has also been documented at the level of certain departments, especially the core departments than support departments.
3- The majority of studies documented a positive association between cost stickiness and the agency problem and provided empirical evidence confirming the strengthening of strong corporate governance, from the impact of the agency problem on the cost stickiness while providing empirical evidence confirming the mitigation of weak corporate governance from the impact of the agency problem on cost stickiness or diminishes it.
4- The scarcity of studies that examined the effect of the agency problem on cost stickiness in Egypt and therefore none of them

addressed the effect of the agency problem modified by corporate governance on cost stickiness, hence the research gap in which the research problem was identified.

4- Research objective:

The main objective of the research is to determine the impact of agency theory upon cost stickiness, by determining the cost behavior in Egypt and identifying agency drivers.

5- Research importance:

The importance of the research is represented in studying a contemporary topic that has scientific and practical importance, from the scientific point of view the research tries to help those interested in studying cost behavior to understand the asymmetric cost behavior, from the practical point of view the research seeks to investigate the relationship between cost stickiness and agency problem.

6- Research hypotheses:

To achieve research objective, different hypotheses were developed as follows:

H_1 Cost behavior is asymmetric on average, costs respond asymmetrically to an equivalent sales change.

H_2 There is a positive significant relationship between agency problem and cost stickiness.

7- Research methodology:

To attain the research objectives, the researcher followed the inductive approach through extrapolation previous research and literature in the field of research related to cost stickiness and agency theory.

8- Research limitations:

The research has some limitations which could be presented as follows:

- The research focuses on agency drivers of asymmetric cost behavior without discussing economic and firm specific characteristics drivers of cost asymmetry.
- The theoretical rooting for agency theory is out of the scope of this research.

9- Research plan:

To achieve research objectives, this research was divided into the following sections:

9/1 The cost stickiness phenomenon

9/2 Agency theory

9/3 Agency drivers of asymmetric cost behavior

9/4 Summary and research results

References

9/1 The cost stickiness phenomenon:

the traditional cost assumption states that the relationship between cost and activity volume is a symmetric relationship when activity level increases or decreases, in other words, costs change symmetrically with changes in activity level which called symmetric cost behavior **(Özkaya, 2020)**.The traditional cost assumption is challenged by several studies which argue that the traditional cost behavior assumption is not always valid and the relationship between costs and activity is not always linear or proportional. The modern era began with the study of **(ABJ, 2003)** which considered the pioneering paper in this research area.

Depending on the results of **(Noreen and Soderstrom, 1994 and 1997)**, (**ABJ, 2003**) supported by empirical research that the magnitude of a change in costs relies not only on the extent of a change in the activity level, but also on the change direction, moreover, they found that SG&A of a US sample increase by 0.55 per cent per 1 percent increase in demand, but decrease by only 0.35 per cent per 1 percent decrease in demand, which implies that costs behave asymmetrically, they interpreted this phenomenon as the cost stickiness phenomenon and label these costs as sticky costs.

Therefore, according to (**ABJ, 2003**) costs are sticky if the magnitude of the increase in costs associated with an increase in activity volume is larger than the magnitude of the decrease in costs associated with an equivalent decrease in volume, the researcher can define the sticky costs as costs with a random reaction towards equivalent changes in the activity level.

According to (**ABJ, 2003**), Sticky behavior is the result of decisions made by managers when activity decreases as when activity drops, the manager must decide whether to:

- Maintain committed resources and bear the cost of unused capacity at least in the short-term or
- Immediately reduce committed resources and incur potentially large retrenching costs in the current period and, if activity increases in the future, incur further costs to reacquire resources.

Another component of the asymmetric cost phenomenon is the cost anti-stickiness that occurs if costs increase less when sales revenue increases, but costs decrease more when sales revenue decreases **(Weiss, 2010; Banker et al., 2013; and Balakrishnan et al., 2014)**.

9/2 Agency theory:

Agency theory was developed by **(Jensen and Meckling, 1976)**, and it was established to study the management's incentives, also agency theory is developed to explain the behavior and relationship between shareholders (principals) who are the owners of firms and managers (agents), they enter a contract in which the principals assign authority and responsibility to agents and agents perform works on behalf of the principals which involves delegating some decision making authority to agents, the agreed contract, or incentive plan encourages the agents to act in the way that is aligned with the interests of principals, hence agency problems arise due to the separation of ownership and management which is a characteristic of modern business operations.

According to **(Pichetkun, 2012)** methods of controlling the action of managers include auditing, monitoring measures, rewards and penalties to encourage managers to behave in the way which is fully matched with shareholder's interests, when managers fail to make decisions aligned with the best interests of the firm this is regarded as divergent behavior such as empire building, moreover, agency theory predicts that this divergent behavior will happen if not constrained by Corporate Governance **(CG)**.

The shareholders have to hire agents to manage the business further, principals as the owners of firms would like to maximize the firm value, but managers' interests cannot be fully aligned with the principals' interests, which gives rise to agency problem **(Kontesa and Brahmana, 2018)**. Therefore, the researcher can conclude that agency theory predicts that managers' interests cannot be fully matched with shareholders' interests as managers tend to chase their personal utilities rather than fully contributing to the value of the firms.

According to **(Ibrahim, 1988; El Gebaly, 1994; and El Gebaly and Ali, 2013)** the agency theory is based on some assumptions which explain the opportunistic relation between principals and agents as follows:

- The economic rationality assumption: the agent and the principal are characterized by economic rationality, each of them seeks to maximize his personal interests.
- The conflict of interests assumption: there is a misalignment of interests between agents and principals.
- The agent motivation assumption: the principal always seeks to motivate the agent to bear responsibilities and take decisions that achieve the interest of the firm.
- The information asymmetry between the agent and the principal assumption: the agent provides information that misleads the principal.

- The risk assumption: the agent and the principal share risk taking, so the principal should know the agent's tendencies and willingness to bear the risk.

Regarding cost stickiness, while adjustment costs are the main economic drivers of sticky cost behavior, a few more recent studies take a closer look at the self-interested incentives and agency conflicts as important determinants of cost stickiness as **(Chen et al., 2012; Kama and Weiss, 2013; and Zhang, 2016)** indicated that conflict of interests between managers and shareholders can be considered as a key reason for cost stickiness as managers seek to pursue their personal utility by adding too much resources which raises their compensation and controlled resources in case of demand increase, but in case of demand decrease, managers don't actively cut costs down for their own interests interests and keep unused resources to avoid personal consequences of retrenchment such as loss of status when a division is downsized or the anguish of dismissing employees, this self-interested decisions keep costs away from the optimal levels, contributing to the cost stickiness phenomenon.

In this regard, **(Chen et al., 2014)** pointed out that the agency explanation for cost stickiness and the economic explanation for cost stickiness are contradictory, as the economic explanation for cost stickiness implies that cost stickiness results from managerial optimal resource allocation decision rules, that are generally asymmetric with respect to the adjustment costs, in contrast, the explanation of agency theory for cost stickiness suggests that cost stickiness is a value-destroying behavior driven by self-interested managers who retain unused resources when activity declines for chasing their own goals, furthermore, authors stated also that the effect of agency problem on cost stickiness can be mitigated by good CG.

9/3 Agency drivers of asymmetric cost behavior:

The agency explanation for cost stickiness has two implications, on one hand, empire building in the sense of retaining excess resources to benefit from the size of the firm **(Jensen and Meckling, 1976)**, which will increase the degree of cost stickiness **(Chen et al., 2012)**. On the other hand, earnings management in the sense of incentives to meet earnings targets and hence cutting excess resources will reduce the cost stickiness degree **(Dierynck et al., 2012; Kama and Weiss, 2013)**.

9/3/1 Empire building:

A well documented agency problem is managerial ‘‘empire building’’, that refers to the tendencies of managers to grow the firm beyond its optimal size or to retain redundant resources with the aim of increasing personal utility from status, power, compensation, and prestige **(Jensen, 1986)**.

Chen et al., 2012 indicated that because SG&A costs include most of the overhead costs incurred in the corporate offices such as salaries and commissions of salespersons, office payroll and expenses, travel and entertainment, managers with empire building incentives are more willing to increase SG&A costs too quickly by adding office payroll and expenses too rapidly when sales increase or to reduce SG&A costs too slowly by delaying the reduction of office payroll and expenses when sales decline, such behavior will shift SG&A cost asymmetry away from its optimal level and lead to higher SG&A cost asymmetry than dictated by economic factors which implies a positive association between the agency problem and the degree of SG&A cost asymmetry, that is, the stronger the empire building incentives, and this relation can be mitigated by CG.

- **Variables of empire building incentives:**

Depending upon the empire building and the downsize literature to identify the relation between the agency problem and cost stickiness, **(Chen et al., 2012; Zhang, 2016)** used five variables to capture managers' empire building incentives arising from the agency problem:

1. **Free Cash Flow:**

Managers who act as agents for shareholders have authorization to make adjustment on costs, when they make decisions deliberately and ignore the optimal development level for companies, the agency problems arise, free cash flow (FCF) is a commonly used proxy for the agency problem and the resulting empire building incentives, free cash flow is defined as cash flow in excess of that required to fund all projects, FCF interprets the cash which a company generates after laying out the expenses to retain operation that considered a measurement of financial performance, furthermore, holding high levels of unused FCF makes managers choose to overinvest in operations, these results suggest that more severe agency conflicts could occur in companies that have larger amount of FCF **(Jensen, 1986)**.

The way in which managers use FCF reflects the incentives of managers, based on the agency theory and prior literatures, self-interested managers would make use of the FCF for their personal utility instead of for the companies' development, the high levels of FCF grant managers opportunities to over-invest in operation costs that are beneficial to their personal interests when demand increases and maintaining unutilized costs when demand decreases which leads to a higher degree of cost stickiness, In contrast, when FCF is low, managers have less opportunity for empire building and retaining unutilized costs and they are more likely to cut unutilized costs when demand decreases in order to avoid negative consequences for their career development **(Zhang, 2016)**.

2. **Chief Executive Officer's tenure:**

Another factor that influences managers' empire building incentives is chief executive officer tenure (CEO). CEO tenure is explained as the years in which managers act as CEOs, CEOs usually need time to build up their power and gain influence on the inside firms **(Zhang, 2016)**. Consistently, **(Chen et al., 2012)** pointed out that CEOs with long tenures are more likely to be entrenched in their positions because they have had more time to build coalitions and accumulate power, therefore, they tend to have more control over the board and other internal monitoring mechanisms and are more likely to achieve their own interests rather than the shareholders' interests.

In this regard, **(Ali and Zhang, 2015)** found that CEOs would execute greater extend of earnings management in the early years and this relation can be alleviated by internal and external monitoring mechanisms, they concluded that the CEO tenure has a positive relationship with agency problems as CEOs have greater power and more opportunities to chase their personal benefits.

3. Chief Executive Officer's horizon:

Managers are motivated to empire build because they expect to gain greater prestige and higher compensation if they increase the size of firm **(Rose and Shepard 1997)**. Because the expected accumulated benefits such as prestige and compensation increase with the horizon of manager (i.e., the number of years that manager expects to stay in office), a manager’s empire building incentives should increase with horizon resulting in cost stickiness, for managers who approach retirement or expect to leave their firms within a short period of time, the expected benefits from empire building will accrue to their successors rather than to themselves, which should decrease their empire building incentives resulting in a lower degree of cost stickiness **(Chen et al., 2012)**.

4. Chief Executive Officer's age:

CEO's age could be considered as another proxy for agency problems, personal characteristics are considered a factor that is influenced by CEO's age as these characteristics change with age and would influence the decisions of CEOs **(Zhang, 2016)**. **Bertrand and Mullainathan, 2003** pointed out that CEOs prefer a quiet life when they grow older, the costly assignments that could bring pressure or destroy their reputation would not be regarded seriously by CEOs. The researcher can conclude that CEOs with older age have more incentives to protect their personal benefits and reputation and would keep unutilized costs to avoid more costly projects as they prefer a quiet life, moreover, when CEOs have more risk-adverse incentives with older age, they would prefer to protect their present benefits rather than gaining more potential value for firms.

5. Chief Executive Officer's compensation:

The structure of managers' compensation schemes is considered one of the most important and essential incentives for empire building, when the proportion of fixed income in CEO compensation packages decreases (increase in variable income), managers in case of demand increase have greater incentives to overinvest under uncertainty as an increase in investment is used as an instrument to extract variable income, enhance prestige and power, and generate resources to be consumed as private, likewise, a decrease in fixed income leads to a delay in cutting slack resources when activity decreases in order to preserve the size of responsibilities that are directly related to variable rewards, which makes costs increase more than they decrease causing cost stickiness, on the other hand, as the fixed income increases, the agency's conflicts decrease as a result managers increase resources normally when demand increases, moreover, managers cut unused resources when demand decreases to avoid losses as managers prefer quiet life which make costs response symmetrically to demand change, which in turn decreases the cost stickiness degree, therefore, cost stickiness is negatively associated with the percentage of fixed compensation **(Chen et al., 2013)**.

- **Disincentives to downsize:**

From the agency conflict perspective, **(ABJ, 2003)** supposed that cost stickiness could occur because of the fact that managers deliberately adjust resources in response to the sales revenue's changes. According to **(Datta et al., 2010)** managers hold self interested incentives to avoid the pressure of downsizing in sales revenue or the potential complains from dismissed employees as follows:

-Managers capture monetary and nonmonetary benefits from managing larger and more complex firms.

-As a response to the decreased performance, many downsizings target management and white-collar staff rather than the firm's productive core, especially when there is a more independent board and efficient market.

-The benefits from downsizing accrue primarily to shareholders rather than managers.

-Managers may favor the quiet life and evade responsibilities, as a result, they try to avoid the difficult decisions and costly efforts related to downsizing.

Therefore, drawing on the agency and downsizing literature the researcher can conclude that the above mentioned manager's disincentives to downsize encourage managers to keep unused resources to retain personal benefits when demand goes down, in the same time, these disincentives to downsize represent motivations to increase resources excessively when demand goes up, which in turn making costs increase too rapidly than they decrease causing a higher degree of cost stickiness in the light of the existence of these disincentives than its absence.

9/3/2 Earnings Management:

Taking into consideration the wide-spread nature of agency problems in modern firms, it is unlikely that managers would behave as expected in an ideal world (i.e., adjustment cost and expectation considerations) **(Jensen and Mecking, 1976)**. Consistent with the literature of agency problems and earnings management **(Xue and Hong, 2016)** stated that there are obvious conflicts between self-interested managers and shareholders such as earnings management behavior under compensation contracts also managers tend to adjust earnings in order to obtain higher compensation, while under pressure to avoid breaching debt contracts, managers are also likely to choose among accounting policies, moreover, prior studies have attributed an increase in earnings management because of the incentives of meeting or beating last year’s earnings, avoiding reporting losses, and meeting or beating analysts’ forecasts.

Kama and Weiss, 2013 mentioned that an earning target could be a trigger for firms’ cost saving which affects the cost stickiness degree, the authors argued that cost stickiness is alleviated when managers face incentives to avoid losses or earnings decreases, or to meet forecasts of financial analysts, because managers accelerate cutting slack resources in response to demand decline at a faster rate than in the absence of these incentives which mitigates, rather than induces, cost stickiness.

Consistent with prior papers **(Koo et al., 2015)** examined the association between earnings management and cost stickiness for a sample of US firms, the results showed that when activity falls, managers cut down costs aggressively to manage earnings, which alleviates cost stickiness, while firms with fewer earnings management incentives were found to exhibit greater cost stickiness.

9/4 Summary and research results:

The purpose of the research was to investigate the effect of agency theory upon cost stickiness by discussing the origin of cost stickiness phenomenon, agency theory, and main agency drivers of cost asymmetry, hence at the end of the research, the researcher concluded the following results:

1- Costs exhibit an asymmetric behavior on average.
2- Agency theory considered as the main driver of cost asymmetry.
3- Empire building incentives for self-interested managers drive the sticky cost behavior (through five drivers which are (FCF, CEO's tenure, CEO's horizon, CEO's age, and CEO's compensation), as managers increase resources when demand rises and delay cutting unused resources when demand drops resulting in a higher degree of cost stickiness.
4- Earnings management incentives reduce the cost stickiness degree as managers seek to meet earnings target by delaying the increase of needed resources when demand rises and cutting unused resources when demand drops resulting in a lower degree of cost stickiness.

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