The purpose of this study was to find out the existence of cost stickiness behavior in Pakistani firms and find mediating role of cost stickiness between earnings management and firm performance. In order to measure cost stickiness, this study use SG&A cost as an proxy and employed Anderson et. Al (2003) model. To measure earnings management, non-discretionary accruals was find out by using the Modified Jones Model (1991). Return on asset (ROA) and Return on equity (ROE) was taken as measure of firm performance. The finding of the study shows that manufacturing firms listed in KSE 100 Index (2017) shows the cost stickiness behavior. Cost increase by 0.54% due to 1% increase in the firm activity while decrease by 0.24% for 1% decrease in the firm sales volume or activity level. This study conclude that earnings management has significant positive relationship with ROE and ROA, showing that higher the earnings management higher the firm performance. This study also concluded that earnings management has significant relationship with cost stickiness which means that higher the earnings management in the firm, lower the cost stickiness level. Relationship between cost stickiness and firm performance was also checked. Findings shows that cost stickiness has negative and insignificant relationship with ROA while has significant and negative relationship with ROE. At the end, mediation analysis was run by using AMOS 21. Mediation analysis shows that cost stickiness play a mediating role between earnings management and cost stickiness.
Based on the findings this study recommends that, boards of directors should monitor the cost related activities and financials of the firms more carefully. It is proposed that managers of the companies must identify and control the cost behavior of their companies and consider it in the processes of decision making. As earning management show the positive impact on the performance, managers try to increase the agency cost to produce signaling effect but in the long run this may effect adversely (as in the case of Enron, WorldCall etc.) therefore, Board of directors should have a vigilant eye on cost measurement and reporting procedure to avoid earnings management.
Keywords: Earnings Management, Cost Stickiness, Firm Performance