SESSION 2: CEO AND DIRECTORS' REMUNERATION

EARNINGS MANAGEMENT AND ASYMMETRIC SENSITIVITY OF BONUS COMPENSATION TO EARNINGS FOR HIGH-GROWTH FIRMS

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Abstract

In this study, we examine whether high-IOS (investment opportunity set) firms *vis-à-vis* non-growth (low-IOS) firms will not reduce discretionary expenditures, such as advertising expenses, research and development, and selling, general and administrative (SG&A) expenses, to further sustain the firm growth in a more conservative reporting environment (the post-Sarbanes-Oxley (SOX) period). We also investigate, as an extension of a prior paper, the sensitivity of chief executive officer (CEO) bonuses to earnings in the cases of high-IOS and low-IOS firms. As we hypothesize, both high-IOS and low-IOS firms showed significant decreases in the sensitivity after SOX. Also, our empirical evidence is also consistent with Lobo and Zhou's (2006) observations that high-IOS and low-IOS firms are more conservative in financial reporting in the first two years after SOX because of required regulatory changes. Consistent with prior research, IOS is measured by the principal component of four IOS proxies. The principal component was calculated from eigenvectors (coefficients) and the four proxies at

the beginning of fiscal year *t*, where *t* belongs to the pre-SOX period (1995–2000) and the post-SOX period (2002–2007). The high-IOS firm years in the pre-SOX (post-SOX) period were those with IOS composite scores above the pre-SOX (post-SOX) period sample median; the low-IOS firm years were those with IOS composite scores below the pre-SOX (post-SOX) period sample median. Empirical evidence generally supports the above hypotheses. As in Zang (2012), the data was winsorized at both ends at the level of 2.5%. In terms of contributions and limitations of this study, we use the investment opportunity set variable (IOS) as a proxy for firm growth. The proxy was more recommended by prior research and is measured by the principal component of four IOS proxies (investment intensity, geometric mean annual growth rate of the market value of total assets, market-to-book value of total assets, and research and development expenditure to total assets) rather than the simple, frequently-used proxy for firm growth (the market-to-book (MTB) value of assets). The evidence of high-IOS firms' increase in discretionary expenditures (and decrease in real earnings management) even after SOX and the effects of SOX and other concurrent reforms on the sensitivity of executive bonus compensation-to-earnings changes are considered to be particularly useful information for regulators, managers, politicians, investors, and academics in their assessment of the earning-management methods differently adopted by high-IOS and low-IOS firms and the equitable relationship between executive efforts and executive compensation for firms affected by the SOX Act and levels of IOS. The potential limitations of this manuscript are obviously related to the use of proxies (IOS), especially for firm growth and earnings management models, which are usual for many empirical studies. Also, our findings should be understood within the context that the study relied on data from the USA, a developed country. Therefore, the findings may not be generalized to firms operating in developing countries.

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