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Organisation capital and sticky behaviour of selling, general and administrative expenses

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ABSTRACT

This study investigates how a firm's view towards intangible-related economic sacrifices affects the stickiness of selling, general and administrative (SG&A) expenses. The sticky cost phenomenon is an alternative pattern of cost behaviour which attributes an explicit role to managerial deliberate resource-commitment decisions. We speculate that, in a sales decline, firms with high levels of intangible assets increase the slack of their unutilised resources more than firms with low levels of intangible assets. This is because a high level of intangible investments increases the level of adjustment costs and drives managers to shape more optimistic expectations regarding whether future sales growth will absorb the slack of unutilised resources. The level of organisation capital is selected as the primary variable of a firm's intensity of intangible investments in order to examine the relation between the cost behaviour of SG&A expenses and intangible investments. The data sample consists of 55,769 firm-year observations of US listed firms for the period 1979–2009. Our empirical findings suggest that in the case of firms with high (low) organisation capital, SG&A expenses exhibit sticky (anti-sticky) cost behaviour.

1. Introduction

A fundamental assumption in cost accounting literature is that the relationship between costs and activity volume is symmetrical for both volume increases and decreases, implying that the magnitude of a change in costs depends solely on the extent of a change in the level of activity, regardless of the direction of the change. Anderson et al. (2003) challenged this assumption by providing evidence for the sticky cost phenomenon in the case of selling, general and administrative (SG&A) expenses. Specifically, they documented that the magnitude of an increase in SG&A expenses, associated with an increase in economic activity, is greater than the magnitude of a decrease in SG&A expenses associated with an equivalent decrease in economic activity.

The current study explores the relationship between organisation capital and the cost behaviour of SG&A expenses. We speculate that in the case of high (low) intangible-intensive firms, SG&A expenses exhibit cost-stickiness (anti-stickiness) behaviour. Organisation capital is selected as a major indicator of a firm's commitment to intangible investments since it is considered the most important unreported intangible resource (Lev et al., 2009). Furthermore, the development of organisation capital is associated with SG&A expenses (Edvinsson and Malone, 1997; Lev et al., 2009).

We rationalise the relationship between organisation capital and the cost behaviour of SG&A expenses within the context of Banker and Byzalov's (2015) integrated explanatory framework for the sticky cost phenomenon. During a

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sales decline, firms with high levels of organisation capital increase the slack of unutilised resources more than firms with low levels of organisation capital. A possible reason for the increased slack of unutilised resources is that the presence of high levels of organisation capital increases the relevant period's level of adjustment costs and causes managers to shape more optimistic expectations regarding whether future sales growth can absorb this increased slack of unutilised resources. The increased slack of unutilised resources affects the cost behaviour of SG&A expenses.

Our empirical evidence suggests that firms with high (low) organisation capital exhibit SG&A cost-stickiness (anti-stickiness) behaviour. We also document that relatively large economic activity changes (over 10%) motivate managerial behaviour to a greater extent than relatively small ones and therefore the difference in the cost behaviour of SG&A expenses between firms with high and low organisation capital is more profound. Our results are robust in relation to various contributing factors associated with the intensity of the sticky cost phenomenon. Additional evidence supports the generalisation of our findings to include other types of expenses (i.e. advertising expenses) or other measures associated with a firm's level of intangibles (i.e. R&D capital).

Management accounting literature assumes that the sticky cost phenomenon is attributed to managerial behaviour. However, the sticky cost-related literature appears to ignore the importance of intangible investments in managerial resource-allocation decisions and, consequently, in asymmetric cost behaviour. The current study contributes to the management accounting literature by expanding our understanding of cost behaviour in the light of a firm's intensity of intangible investments and the underlying managerial behaviour. Our findings demonstrate that resource-allocation decisions regarding the development of intangibles trigger the sticky cost phenomenon. In firms with high organisation capital, it is plausible to assume that managers have a relatively long-term orientated performance horizon and, thus, they decide to maintain the level of SG&A expenses in the face of sales declines since SG&A expenses are viewed as investments that are associated with high adjustment costs and expectations for increased future sales.

Furthermore, our study extends the empirical results of intangible-related literature in two ways. Firstly, it provides evidence for the role of intangible investments within a firm's cost structure by documenting a strong relationship between organisation capital and SG&A cost asymmetric behaviour. Secondly, our findings suggest that the behaviour of intangible-related expenses deviates from the traditional microeconomic cost model.

Our data sample consists of 55,769 firm-year observations of US listed firms over the period 1979–2009. Data are obtained from North America Compustat. We calculate organisation capital using an approach similar to that proposed by Lev et al. (2009) and we examine SG&A stickiness in the presence of organisation capital following the methodology proposed by Anderson et al. (2003).

The paper proceeds as follows: In Section 2 we describe the sticky cost phenomenon and intellectual capital theory. The motivation and the research hypothesis are presented in Section 3. Section 4 discusses the sample selection and the methodology. Section 5 presents the empirical results. Sections 6 and 7 develop the additional analysis and the robustness tests respectively. Finally, Section 8 concludes.

2. Background

2.1. Sticky cost phenomenon

The traditional view of cost behaviour is based on the microeconomic distinction of costs as fixed versus variable with respect to changes in the activity volume of the current fiscal year (Noreen, 1991). Within this mechanistic setting, the behaviour of total variable costs is contemporaneous, linear and symmetric as regards both increases and decreases in sales volume. The magnitude of changes occurring in the variable costs is independent of the costs and activity volume of the prior fiscal year. Moreover, managers do not play an explicit role in affecting cost behaviour with their deliverable decisions.

The sticky cost phenomenon is an alternative pattern of cost behaviour (Anderson et al., 2003). Sticky cost literature distinguishes between costs that move mechanistically with changes in volume and the costs that are determined by resources committed by managers. Costs are sticky if the magnitude of their increase (which is associated with an increase in economic activity), is greater than the magnitude of their decrease associated with an equivalent decrease in economic activity. In some cases, costs exhibit anti-sticky behaviour, that is, the cost response to an activity level decrease is greater than in the case of an activity increase (Balakrishnan et al., 2004). Sticky cost behaviour has been attributed to deliberate resource-commitment decisions made by managers to maintain idle resources after volume declines[3] and it has been observed in different cost categories such as: SG&A expenses (Anderson et al., 2003; Chen et al., 2012); cost of goods sold (COGS); and operating costs (Balakrishnan and Gruca, 2008; Kama and Weiss, 2013). The same literature has attempted to explain the sticky cost phenomenon using economic factors such as adjustment costs, magnitude of economic activity change, anticipations of future sales and managerial empire-building behaviour.

2.1.1. Adjustment costs

According to Anderson et al. (2003), cost stickiness is positively correlated with the magnitude of adjustment costs. Adjustment costs are economic sacrifices, social, contracting or psychological costs which emerge during the resource-adjustment process (e.g. severance payments, diminished morale, disruptions to on-going work, human resource development costs relating to increasing demand). A high level of adjustment costs prevents managers from reducing discretionary-resource consumption proportionally to reductions in the firm's level of economic activity (Anderson et al., 2003; Banker and Byzalov, 2015; Calleja et al., 2006). Adjustment costs,

[3] The retention of idle resources is used by a few studies in order to explain the relationship between cost change and future profitability (Banker and Chen, 2006; Baumgarten et al., 2010).