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Abstract

In fundamental analysi neral, and administrative costs to sales (the SG&A cost ratio) between two periods as a negative signal about future profitability and firm value. Implicit in this interpretation is an expectation that SG&A costs should normally move proportionately with increases or decreases in revenues, and that an increase in the ratio signals management inefficiency in controlling costs. While this expectation provides a straightforward interpretation for analysis purposes, it ignores important aspects of SG&A cost behavior. We observe that both fixity of costs and stickiness of costs may cause the ratio of SG&A costs to sales to increase, rather than decrease proportionately with sales, when revenue declines. Sticky costs, in fact, may represent deliberate retention of SG&A resources based on managers' expectations that revenue will increase in the future. In this case, an increase in the SG&A cost ratio may actually convey positive information about managers' expectations of future earnings. We estimate an earnings prediction model and find that future earnings are positively related to changes in the SG&A cost ratio in periods in which revenue declines, inconsistent with traditional interpretation of SG&A cost changes. We also find that abnormal positive returns may be earned on portfolios formed by going long on firms with high increases in the SG&A cost ratio (and short on firms with low increases in the SG&A cost ratio) in revenue-declining periods.

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