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# Payout policy, managerial perquisites, and sticky SG&A costs

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## Abstract

**Background:** Sticky SG&A costs provide a novel opportunity to investigate whether payout policy serves as a remedy for management overspending on perquisites that are embedded in SG&A expenses. Payout policy, especially under strong governance, may reduce overspending. Another possibility is that management may use sales declines opportunistically to repurchase shares when sales are expected to rebound.

**Methods:** Regression analysis is used to examine the effect of payout mechanisms (dividends, share repurchases, and combinations thereof) and shareholder rights (EIndex) to determine whether managerial overspending on perquisites is reduced through payout policy.

**Results:** The results indicate that dividends and share repurchases are associated with reduced SG&A cost stickiness. Payout policy reduces sticky SG&A costs under both strong and weak governance, where dividend payout is significant only for firms with strong governance, and share repurchases primarily significant for firms with weak governance.

**Conclusion:** Under strong governance, dividends are significantly associated with reduced SG&A cost stickiness, supporting agency theory. However, strongly governed dividend payers are only significant when they also repurchase shares. For the weak governance sample, dividends are not significant, but share repurchase is significantly associated with less sticky SG&A costs, consistent with weakly governed management repurchasing shares in times of lower sales to improve earnings per share, reduce SG&A expenses to improve net income, and fund the share repurchases.

## KEYWORDS

agency theory, dividends, EIndex, EPS target, free cash flow hypothesis, governance, managerial overspending, outcome model, payout policy, share repurchase, sticky costs

## 1 | INTRODUCTION

According to agency theory, managers will overindulge in perquisites, but the firm's owners can reduce overspending with payout policy. Most indulgent managerial perquisites such as personal services, autos, and luxury items are recorded as SG&A costs. This is an empirical study to deter-

mine whether payout policy reduces management's overspending on SG&A costs that include perquisites. Previous studies have not examined empirically whether the commitment to consistent dividend payout will alleviate overspending in managerial perquisites. Although the baseline spending on perquisites is elusive, they are largely contained in SG&A costs, and SG&A costs should move con-

sistently with revenues. Chen et al. (2012) find evidence that the asymmetry of responsiveness to revenues is due to agency problems, suggesting that the asymmetry represents an agency cost of managerial perquisites and over-spending. Discipline imposed through dividends and share repurchases should reduce perquisites, luxuries such as unnecessary corporate jets, and value depreciating projects (Farre-Mense et al., 2014; Jensen, 1986).

Although researchers use the academic label, “sticky SG&A costs,” the concept of tightly controlling SG&A expenses through upturns and downturns in sales is among the most pragmatic research topics relating to managerial accounting and operations. Interest in the topic was sparked because a large-scale study on publicly traded firms determined that in practice, SG&A costs are significantly less responsive to revenue declines than revenue increases (Anderson et al., 2003), and this asymmetry of cost management with sales growth versus sales declines is referred to as “sticky SG&A costs.”

According to the free cash flow hypothesis, agency costs such as those encapsulated in SG&A expenses can be reduced by the firm’s payout policy (Jensen, 1986). Specifically, the agency problem is that management prefers to overinvest in value-depreciating projects, spend wastefully on perquisites, or perpetuate inefficient administrative expenses. Jensen (1986) explains that a regimented payout of cash with recurring dividends reduces the recurring cash flow available to management, thereby reducing the agency problem. Previous studies have examined the effect of payout policy on investment and firm performance, but to the author’s knowledge this study is the first to evaluate whether the firm’s choice of policy for residual cash payout affects management’s performance in maintaining tight control of SG&A costs through changes in sales activity.

SG&A expenses are important because many of the managerial perquisites referred to as wasteful spending, such as luxury transportation and personal services, are aggregated with other business expenses under SG&A costs. It is difficult to quantify the ideal amount of SG&A expense or determine what portion of SG&A represents an agency cost because of the lack of a benchmark. The semi-fixed nature of SG&A costs is more difficult to align with changes in sales than costs of goods, which is variable. Therefore, Sticky SG&A cost analysis provides a benchmark from within the firm’s own cost structure. SG&A costs are designated as sticky because they decrease with sales declines more slowly than they increase with sales increases. The stickiness, or asymmetry, of SG&A costs is evidence of potential cost reductions that were passed over by management because when sales declined, management did not reduce SG&A expenses as quickly as the SG&A expenses increased with sales increases.

Recent studies on SG&A cost stickiness have associated the asymmetry with proxies for agency theory, making the argument that cost stickiness is due to agency conflicts. These articles have addressed the association of managerial power and governance with sticky SG&A costs, but have not evaluated payout policy as a remedy in accordance with agency theory and the free cash flow hypothesis. Other studies conclude that costs are sticky because management has inside information that sales will rebound, and the higher level of expenses during the downturn represent staffing and resources that will be immediately available when sales increase (Brüggen & Zehnder, 2014). Aligning this theory with payout policy, management should be repurchasing shares to signal their good news of expected higher future sales to the market while taking advantage of potentially lower market prices, and there would be a positive association with sticky SG&A costs and share repurchases, opposite from agency theory.

The purpose of this paper is to determine the relationship between payout policy and sticky SG&A expenses. A second contribution is to examine the role of governance in the relationship between payout policy and sticky SG&A expenses.

This study follows the methodology of Chen et al. (2012) to examine the effectiveness of agency remedies for sticky SG&A costs. Excess cash can be reduced through the payment of dividends and/or the repurchase of stock. Does reducing free cash flow motivate management to control administrative costs more tightly to changes in sales? The results of regression analysis show that payout policy using dividends and share repurchases reduces sticky SG&A costs. Moreover, when the effects of governance are included, dividend payout under strong governance is a significant determinant of SG&A stickiness. Its effectiveness in reducing SG&A costs is evidenced in firms with powerful shareholders but is not significant in the sample of firms with weak shareholders. Furthermore, in the sample of strong governance firms, the dividend payout is not significant for dividend payers that do not also repurchase shares.

For share repurchases, the findings under the effects of strong versus weak governance are somewhat mixed. Although share repurchase has been found to reduce agency costs in prior literature, regression results produce weak evidence of this and only for firms that do not pay dividends. In contrast, share repurchase is highly significant in reducing sticky SG&A costs in firms with weak governance, which is inconsistent with the idea that strong shareholders extract share repurchases to reduce spending on perquisites. Instead, the negative relationship between share repurchases and sticky SG&A costs under weak governance is consistent with management using repurchases to manage earnings per share (EPS).



In the following section, the hypotheses are developed. The data and methodology are detailed in Section 3, and results are explained in Section 4. A summary and conclusion is presented in Section 5.

## **2 | LITERATURE AND HYPOTHESIS DEVELOPMENT**

### **2.1 | Sticky SG&A costs**

Shareholders absorb an agency cost when management overinvests in acquisitions, overspends on perquisites, or wastes resources due to operational slack. Management is incentivized to overinvest in value depreciating projects, and research has shown that strong governance is required to mitigate the loss of firm value (Bebchuk et al., 2009; Gompers et al., 2003; Grinstein & Hribar, 2004; and Harford et al., 2008). Jensen and Meckling (1976) argue that as the percentage ownership in the firm falls, management has more incentive to extract personal rents from the firm.

Agency costs include managerial perquisites that are a component of SG&A costs. Concealed within this account are expenses related to impressive office estates, organizational support facilities, personal staff, higher salaries, insurance, office furnishings, private aircraft, and company automobiles (Chen & Yur-Austin, 2007; Jelinek & Stuerke, 2009; Singh & Davidson, 2003). Florackis and Ozkan (2009) use SG&A expense as a proxy for agency costs. Extraction of rents is not the only reason put forth for excess spending. Just as CEO overconfidence and hubris have been linked to value-depreciating acquisitions (Malmendier & Tate, 2008; Morck et al., 1990; Roll, 1986), management may delay SG&A cost reductions due to misplaced optimism for future sales. Banker et al. (2008) model prior period performance to estimate the level of management's optimism or pessimism as it relates to SG&A cost decisions. However, Bertrand and Mullainathan (2003) argue that SG&A slack is created because the decision to downsize or reduce staff is difficult, and management delays these actions. Jeong-Ho and Tae-Young (2014) conclude that firms with a stronger owner influence from large shareholders have less sticky costs.

Anderson et al. (2003) examine the changes in SG&A expenses, comparing the adherence of costs to sales in periods of growth and decline. They estimate an asymmetry in SG&A costs where, on average, SG&A costs increase more quickly when sales rise than they decrease with sales declines. The authors suggest two possible explanations for SG&A cost stickiness that are not mutually exclusive. First, the asymmetry in costs may be due to management's expectation that the sales decline will reverse in the near term; therefore downsizing would be cost inefficient for

the long term. A second explanation is that SG&A cost asymmetry is evidence of an agency cost due to management's personal preference to maintain unnecessary resources. Some studies argue that sticky SG&A costs can be explained by management intent (Brüggen & Zehnder, 2014). Baumgarten et al. (2010) use a model to explain when management would intentionally hold costs stickier and find that, in these instances, the choice to allow stickier costs leads to higher long term profitability. Banker et al. (2014) include anti-sticky costs in their study to control for management's strategic allowance of sticky costs to enhance firm performance. Anderson et al. (2007) determine that stickier costs represent management's expectations about future performance, where management deliberately maintains resources when reversals in activity are expected.

Several studies conclude that sticky SG&A costs are aligned with agency problems. Chen et al. (2013) attribute sticky SG&A costs to managerial overconfidence. Chen et al. (2012) argue that sticky SG&A costs are associated with elements of CEO power and managerial empire-building. They examine CEO power proxied by tenure retirement service and compensation, finding a significant, positive association with stickier costs. If agency problems are a cause of sticky costs, then strong governance should moderate the asymmetry. Chen et al. (2012) test six governance factors, finding that they mitigate the agency problem and reduce cost stickiness. Furthermore, Chen et al. (2012) find that costs are stickier in more mature firms where some studies show that weak governance is more pronounced (Chiang et al., 2013). Weiss (2010) determines that stickier costs are associated with higher forecast error and lower analyst following. Extending the investigation to market response, Weiss (2010) determines that investors are less confident in earnings surprises in that they assign a lower value to earnings announcements when costs are stickier. Building on research showing that management manipulates real activities to meet earnings targets (Graham et al., 2005; Roychowdhury, 2006), Kama and Weiss (2013) conclude that sticky costs are attributed to agency theory, and they caution that, in some cases, the agency problem causes less sticky costs. They find evidence that sticky costs represent slack that is manipulated by management to meet earnings targets. Likewise, Dierynck et al. (2012) find that when managers are under more pressure to meet earnings targets, their costs are more symmetrical.

### **2.2 | Dividend payout**

Dividends require an ongoing cash flow commitment because the market responds negatively to cuts in dividend payout. Consequently, firms initiate dividend payout

when management expects to have the resources to sustain dividend payout. Thus dividend payout has been examined as a signal for prospective earnings. Dividend increases are linked to future earnings (Healy & Palepu, 1988), and the permanence of earnings (Benartzi et al., 1997, and Koch & Sun, 2004). He et al. (2020) conclude that the firm's total payout is reduced when the firm has "higher resource adjustment costs" in the form of total cost stickiness.<sup>1</sup> Smith and Pennathur (2019) find that earnings management leading up to dividend initiation is more consistent with agency problems than signaling, as management postpones the commitment to recurring payout. Benartzi et al. (1997) examine signaling and determine that if there is a signal sent by management, the market does not properly interpret it, so there is no point in sending the signal. Fuller and Blau (2010) conclude that firms use dividends to signal to the market, but they do so after using dividends to avert agency problems due to excess cash.

The commitment to a consistent dividend payout provides discipline over management to reduce wasteful spending and agency costs (Jensen, 1986). Investors assign a higher value to increases in EPS for firms that have committed to a recurring dividend (Kallapur, 1994), and assign a lower value to cash reserves when the firm has more agency problems (Dittmar & Mahrt-Smith, 2007). Fuller and Blau (2010) conclude that the highest quality firms pay dividends to reduce agency problems. When firms have more excess cash, they destroy more value with acquisitions (Harford, 1999). Harford et al. (2008) find that firms with strong governance are more likely to pay out excess cash through dividends. Moreover, the authors conclude that firms with weak governance have more excess cash and lower performance. Lawson and Wang (2016) identify a reduction in audit fees for firms that pay dividends due to a reduction in risk of earnings manipulation. Capital market studies conclude that excess cash within the firm is discounted by investors, and the value of a firm's cash is subject to the strength of governance (Faulkender & Wang, 2006; and Dittmar et al., 2003). If sticky SG&A costs are an agency problem as Chen et al. (2012) conclude, then the stickiness should lessen in response to a remedy for agency costs.

**H1:** Dividend payout is negatively associated with sticky SG&A costs.

## 2.3 | Share repurchase

The role of share repurchase in payout policy has increased over time. Firms are more likely now to initiate payout with share repurchases, replacing dividends in this respect (Farre-Mensa et al., 2014). In 2008, Skinner concluded that

share repurchase had become the "dominant form of payout (p. 584)." Payout is comprised of dividends and share purchases, and most firms that pay dividends also repurchase shares (Skinner, 2008).

Share repurchase is an alternate method of reducing excess cash, and management prefers this method because it is more flexible than dividend payout (Brav et al., 2005). Jensen (1986) stated that the consistent payout of dividends constrains the available operating cash flows and imposes spending discipline on management. Dividends are sticky in that once firms initiate payout, the market reacts negatively to a reduction or end of dividend payout, so future cash flows are obligated to dividend payout. In contrast, share repurchases provide management with more flexibility because they are more transient (Farre-Mensa et al., 2014). Yet research on the motivation for share repurchases concludes that, like dividends, they are motivated by agency theory (Allen & Michaely, 2003 and Farre-Mensa et al., 2014).

Aside from agency, two other widely researched motivations for share repurchase are signaling and management of EPS. The discussion below begins with the topic of signaling, then management of EPS, followed by agency and a general summary of the effects related to SG&A cost stickiness.

### 2.3.1 | Signaling

Although signaling is the most cited reason for share repurchase, and some studies find evidence of signaling (Wang et al., 2020), the literature offers "little evidence" for this explanation (Louis & White, 2007: 205). Louis and White (2007) find support for managers' use of fixed-price tender offers to signal that the stock is undervalued, but do not find evidence that Dutch-auction repurchases are used in this manner. Louis and Robinson (2005) find that share repurchases are associated with signaling when combined with earnings management. In their review of payout literature, Farre-Mensa et al. (2014) find that market reaction to share repurchases is not "semi-strong form efficient," suggesting that share repurchases are not an effective signal to the market. The authors conclude that, "... agency theories enjoy the most robust empirical support," in explaining the motivation for payout policy. In their survey of CFO's, Brav et al. (2005), less than 5% of managers considered share repurchase for the purpose of signaling value to the market.

Anderson et al. (2007) use a model for SG&A cost stickiness and conclude that SG&A expenses are not symmetrically reduced during sales declines because management expects future sales to rebound. In a similar study, Baumgarten et al. (2010) examine cost efficient firms that



increase SG&A investment for the purpose of improving “process optimization and operational efficiency (Baumgarten et al., 2010; page 19),” which lowers future costs of goods sold and results in improved operational earnings. Baumgarten et al. (2010) also tested the cost efficient firms with respect to changes in sales and cost stickiness similar to Anderson et al. (2007) but did not find support for the relationship to temporary sales declines.

If management is keeping SG&A costs higher with the expectation that sales will rebound, and management simultaneously repurchases shares as a signal to the market that sales will rebound, then stickier SG&A would be associated with increased share repurchases. However, based on the literature that concludes firms are not using share repurchase as a signal, a hypothesis is not presented for signaling.

### 2.3.2 | EPS

Another motivation for repurchasing stock is to improve EPS. In survey research, management reports earnings targets to be the primary reason for repurchasing shares (Badrinath et al., 2001; Brav et al., 2005). Sell-side analyst reports and financial news reports also indicate that firms repurchase shares to improve EPS. Share repurchase provides firms with a tool for earnings management (Hribar et al., 2006). Hribar et al. (2006) find that many firms would have missed their EPS targets if not for the repurchase of shares, and firms that use share repurchases to engineer earnings surprises are met with diminished market reaction, suggesting that investors discount the induced earnings surprise. The use of share repurchases to improve EPS does not necessarily imply that management would reduce SG&A costs, yet doing so would assist in the goal of improving EPS and provide cash flow for the share repurchase.

### 2.3.3 | Agency theory

The evidence on motivation for payout policy through dividends and share repurchases indicates that it is done to reduce excess cash flows, overspending on perquisites, and overinvestment (Allen & Michaely, 2003 and Farre-Mensa et al., 2014). Farre-Mensa et al. (2014) state that, “...dividends and repurchases can be used as a disciplinary device that reduces the extent to which managers can funnel resources away from shareholders,” and payout policy may limit consumption of perks, private jets, and “spending sprees (Farre-Mensa et al., 2014: 106).” Grullon and Michaely (2002) conclude that share repurchases reduce agency problems, finding that when firms that repurchase shares decrease their dividend payout, the market reaction is less negative than for non-repurchasing firms.

Crane et al. (2016) find evidence supporting agency theory in that higher institutional ownership is associated with higher payout in dividends and share repurchases. Their findings support La Porta et al.’s (2000) outcome model, which states that strong shareholders extract dividends from management. Another example of the outcome model with respect to share repurchase is from an article by Benoit (2013), describing the sway that investor, Carl Icahn, holds over Apple to increase share repurchases to release excess cash. Management may propose the payout to the board of directors, suggesting that management has the control, but management makes proposals they believe will be accepted. In Brav et al.’s (2005) survey of financial executives, more than half of those surveyed say that institutional owners influence dividend and repurchase decisions.

Of the three motivations for share repurchase, signaling has the least empirical support. Furthermore, signaling would only be appropriate in the subset of situations where there is inside information to signal. Managing EPS by repurchasing shares is possible whether management controls SG&A costs tightly or not, although reducing SG&A costs would further improve EPS in the face of declining sales and provide cash flow to fund the repurchase of shares. Under the agency model, if share repurchases are expected by the board of directors and shareholders, firms would also be forced to reduce the stickiness and perquisites in SG&A expenses to meet the cash flow demands for payout expectations. Also following the agency model, stronger governance would demand tighter control over SG&A costs. The arguments for managing EPS and meeting payout demands of shareholders (agency theory) invoke the following hypothesis.

H2: Share repurchase is negatively associated with sticky SG&A costs.

## 2.4 | Governance

Prior studies suggest that agency costs can be moderated in firms with strong governance. For example, when shareholders retain more voting rights, firm value is increased (Bebchuk et al., 2009; Gompers et al., 2003). Tong and Zhang (2014) find that firms create more value with R&D investments when they have more independent board members. Perry and Shivdasani (2005) find that in the presence of activity declines, firms with more independent boards of directors downsize more aggressively and preserve more long term firm value. Conversely, when management is more powerful, acquisitions destroy more value (Grinstein & Hribar, 2004; Harford et al., 2008) earnings are window-dressed using accruals (Chung et al., 2005), and firm value is lower (Bebchuk et al., 2009).

Payout policy stemming from good governance as well as entrenched management is supported in prior literature (Adjaoud & Ben-Amar, 2010). La Porta et al. (2000) propose two possible governance interactions with dividend payout, the outcome model and the substitute model, to determine whether firms pay more dividends under strong or weak governance conditions. According to the outcome model, dividends are an “outcome of strong governance,” and dividends are extracted by shareholders with strong rights. Under the substitute model, managers offer dividends to weak shareholders to gain favor for future seasoned equity offerings. La Porta et al. (2000) identify support for the outcome model in their international study. Harford et al. (2008) study concludes that firms with the strongest governance are more likely to pay out excess cash to shareholders. The outcome model is also supported for dividend payout by Renneboog and Szilagyi (2006) and Michaely and Roberts (2006), and for share repurchases by Jiraporn (2006). Jiraporn et al. (2011) use data from Institutional Shareholder Services and find that firms pay dividends when shareholder rights are strong.

A number of studies find support for the substitute model (Jiraporn & Ning, 2006 and John & Knyazeva, 2006). Jiraporn and Chintrakarn (2009) evaluate the choice between share repurchase and dividends and determine that firms with staggered boards, a protection against takeover, are more likely to pay dividends than repurchase shares. This result supports the substitute model for dividends, because a staggered board is a reduction of shareholder rights. Hu and Kumar (2004) conclude that payout is higher for entrenched managers.

Shareholders can use share repurchases along with dividend payout to improve monitoring over management (Farre-Mensa et al., 2014). Strong governance has been associated with increased incentive compensation (Harvey & Shrieves, 2001 and Harford & Li, 2007), fewer negative net present value acquisitions (Grinstein & Hribar, 2004), lower cost of debt financing (Klock et al., 2005), and higher operating performance (Bebchuk et al., 2004; Gompers et al., 2003; and Bhagat & Bolton, 2008).

The outcome and substitute model are used to explain the amount of payout. Payout that reduces agency problems according to Jensen’s (1986) research is associated with strong shareholders that impose payout policy as discipline over management. This leads to the following hypothesis relative to strong governance, and the result under weak governance is left to empirical determination.

**H3a (Dividends):** Dividends are negatively associated with sticky SG&A costs in firms with strong governance.

Share repurchase could be motivated by management of EPS, or agency. If the share repurchase motivation is to manage EPS, then the activity is more likely to occur with weak shareholders because managing EPS is a short-term goal that may not be consistent with long term shareholder value. Moreover, if the goal is to improve EPS, then reducing sticky SG&A costs would be consistent with that goal. Therefore, the hypothesis follows

**H3b (Share repurchase–EPS):** Share repurchase is negatively associated with sticky SG&A costs in firms with weak governance.

If the motivation for share repurchase is to reduce agency costs and managerial perquisites, then it occurs when strong shareholders extract payout through share repurchase. Thus, share repurchase should be negatively associated with sticky SG&A costs in firms with strong governance, and the hypothesis would follow.

**H3c (Share repurchase–Agency Theory):** Share repurchase is negatively associated with sticky SG&A costs in firms with strong governance.

### 3 | DATA AND METHODOLOGY

The sample of US firms is selected from the Compustat database. Sales must be available for 2 years prior, and SG&A for 1 year prior to the current year. Changes in sales that are opposite in direction from the change in SG&A are removed, as are observations before 1990, following Chen et al. (2012). The measure of shareholders’ rights, EIndex data, is obtained from Institutional Shareholder Services. After creating all variables for the regression, the final sample is 41,832 firm-years,<sup>2</sup> and availability of the EIndex restricts this test to 15,219 firm-years. Following Chen et al. (2012), the following regression (Equation 1) is estimated:

$$\begin{aligned} \log \left( \frac{SG\&A_{i,t}}{SG\&A_{i,t-1}} \right) = & \beta_0 + \beta_1 \log \left( \frac{Sales_{i,t}}{Sales_{i,t-1}} \right) \\ & + \beta_2 DecDummy \cdot \log \left( \frac{Sales_{i,t}}{Sales_{i,t-1}} \right) \\ & + \sum_{m=3}^7 \beta_m DecDummy \cdot \log \left( \frac{Sales_{i,t}}{Sales_{i,t-1}} \right) EconVar_{m,i,t} \\ & + \beta_8 DecDummy \log \left( \frac{Sales_{i,t}}{Sales_{i,t-1}} \right) PayoutProxies_{m,i,t} \\ & + \sum_{s=9}^{13} EconVar_{s,i,t} + \beta_{14} PayoutProxies_{s,i,t} + \varepsilon_{i,t} \end{aligned} \quad (1)$$

TABLE 3 Sample distribution by year

Year	Number of firms	Percent of sample	Cumulative frequency	Cumulative percent
1998	2946	7.04	2946	7.04
1999	2727	6.52	5673	13.56
2000	2501	5.98	8174	19.54
2001	2261	5.4	10,435	24.95
2002	2248	5.37	12,683	30.32
2003	2262	5.41	14,945	35.73
2004	2432	5.81	17,377	41.54
2005	2294	5.48	19,671	47.02
2006	2345	5.61	22,016	52.63
2007	2045	4.89	24,061	57.52
2008	1931	4.62	25,992	62.13
2009	1793	4.29	27,785	66.42
2010	1931	4.62	29,716	71.04
2011	1940	4.64	31,656	75.67
2012	1717	4.1	33,373	79.78
2013	1777	4.25	35,150	84.03
2014	1758	4.2	36,908	88.23
2015	1637	3.91	38,545	92.14
2016	1638	3.92	40,183	96.06
2017	1649	3.94	41,832	100

To test the effect of payout policy on SG&A cost asymmetry, the following *Payout Proxies* are used to represent dividends or share repurchases as stand-alone proxies, and they are also included as interaction terms with  $\text{DecDummy} \cdot \log\left(\frac{\text{Sales}_{i,t}}{\text{Sales}_{i,t-1}}\right)$ . *Payout proxies* are measured as dividends to sales, the amount of cash dividends paid in the fiscal year divided by sales, and share repurchases to sales, the ratio of share repurchases to sales in the current year. The entrenchment index, referred to as the EIndex, is the sum of up to six antitakeover provisions that restrict shareholders' rights as proposed by Bebchuk et al. (2009).

The dependent variable for Equation (1) is the log of the ratio of SG&A (XSGA from Compustat) in the current period divided by the prior period SG&A. The next term is the log of the ratio of sales (SALE from Compustat) in the current period divided by the prior period sales, DecDummy is a dummy variable equal to 1, if the sales in the current year are lower than the prior year. Economic variables include Employee Intensity, the number of employees (EMP from Compustat) scaled by sales, Asset Intensity, total assets (AT from Compustat) scaled by sales, Successive Decrease, a dummy variable equal to 1, if the prior year's sales are lower than 2 years prior, and Stock Performance, which is the raw annual return for the firm in the prior year from Center for Research in Security Prices

(CRSP). A control is also included for debt (DLTT/SALE from Compustat) because Jensen (1986) concludes that debt reduces agency costs.

Test variables are structured to examine firms that pay dividends, firms that pay dividends divided by the firm's share repurchase policy during the sample period, and firms that repurchase shares divided by the firm's share repurchase policy during the sample period. The distinction is important because Skinner (2008) reports that most firms paying dividends also repurchase shares. Therefore, to test the effect of payout policy on SG&A cost asymmetry, the following *Payout* variables are used.<sup>3</sup> Rep(Div)[Rep(NDiv)] is the amount of repurchases for firms that do[do not] pay dividends. Div(Rep)[Div(NRep)] is the amount of dividends paid for firms that do[do not] repurchase shares. Dividends are the amount of dividends paid, whether the firm repurchases shares or not. A firm is a dividend payer (repurchasing firm) if the firm pays common dividends (repurchases shares) at any point during the sample period, and the distribution of this pattern is tabulated (see Table 1 below). These variables are used in the equation as standalone and interacted with  $\text{DecDummy} \cdot \log\left(\frac{\text{Sales}_{i,t}}{\text{Sales}_{i,t-1}}\right)$ .

The entrenchment index, referred to as the EIndex, is the sum of up to six antitakeover provisions that restrict



**TABLE 1** Summary of payout observations

	Number of observations			
	Full sample		EIndex sample	
	Firm-years	Percent	Firm-years	Percent
Dividend payers	13,502	32%	7671	50%
Share repurchasers	18,611	44%	9446	62%
Dividends only	5373	13%	2320	15%
Share repurchase only	10,482	25%	4095	27%
Dividends and share repurchase	8129	19%	5351	35%
Some payout	23,984	57%	11,766	77%
No payout	17,848	43%	3453	23%
Total firm-years	41,832		15,219	

shareholders' rights as proposed by Bebchuk et al. (2009). The sample is divided by firms with an EIndex of three or less (strong governance) versus an EIndex of four or higher (weak governance). For continuous variables, extreme observations in the top and bottom .5% of the sample are eliminated, following Chen et al. (2012).

Descriptive statistics for the sample are shown in Tables 1–3.

Table 2 provides descriptive statistics for the sample. Average sales are \$3824.2 million and median sales are \$462.32 million. SG&A is 28% of sales as an average, close to the median of 24%. Almost twenty-six percent of the sample had a sales decrease in the prior year from the year before (Successive Decrease), and the average stock return (Stock Performance) was 1.26%. Mean dividend payout is \$70.45 million (Dividends [all firms]), and mean share repurchases total \$90.86 million (Share Repurchases [all firms]). The mean (median) EIndex is 2.532 (3.000) out of six antitakeover provisions.

The distribution of the sample over time is shown in Table 3. The lowest number of observations is in 2015, 1637 firm-years, and the highest is in 1998, 2946 firm-years.

Table 1 displays the number of firms that repurchase shares or pay dividends. The full sample, covering the years 1998 through 2017, includes 41,832 firm-years. The majority of firms (57%) uses either dividend or share repurchase payout during the sample period. Thirty-two percent of firm-year observations are for firms that pay dividends and 44% for firms that repurchase shares. Nineteen percent of firm-year observations are for firms that have both forms of payout, paying dividends and repurchasing shares. The EIndex is not available for smaller firms. When the sample is reduced to include only firm-year observations with EIndex data, a higher number of firm-year observations (77%) are for firms that use some form of payout, either by dividends or share repurchases. Fifty percent of firm-year observations are firms that pay dividends, and 62% are firm-year observations for firms that repurchase shares.

Thirty-five percent of firm-year observations are for firms that use both forms of payout.

## 4 | RESULTS

The estimation of Equation (1) is shown in Table 4. In this first estimation, Model 1, the effect of payout is evaluated separately for firms that pay dividends, firms that repurchase shares only, and firms that repurchase shares in addition to paying dividends. In Model 2, dividend payout is separated between firms that also repurchase shares and those that do not repurchase shares.

H1 and H2 state that sticky SG&A costs are lower for firms that pay more in dividends and share repurchases, respectively. Therefore, a positive coefficient is expected on the interaction terms for dividend and share repurchase test proxies. The practical interpretation is that less SG&A cost stickiness indicates tighter managerial control over SG&A expenses in periods of declining revenues.

In Model 1, the coefficient on Dividends is positive and highly significant, suggesting that dividends reduce SG&A stickiness. This is consistent with Jensen's (1986) expectation that dividends reduce excess managerial perquisites and supports H1. The results in Model 1 also show that the coefficient for share repurchases in dividend paying and non-dividend paying firms is positive (Rep(NDiv) and Rep(Div)) and highly significant, consistent with the idea that share repurchases reduce SG&A cost stickiness. This result supports H2.

In Table 4, Model 2, the hypotheses, H1 and H2, are tested again. In this model, dividends are separated by whether the firm also repurchases shares. Dividend payout for firms that do not repurchase shares are associated with reduced SG&A cost stickiness; the finding is significant with 95% confidence. Dividend payout for firms that do repurchase shares is significant at the 10% level, weakly

TABLE 2 Descriptive statistics

	Mean	Minimum	Qtr1	Median	Qtr3	Maximum	Std. dev.
Revenue and SG&A							
SALE	3824.20	1.26	117.78	462.32	1801.13	496,785.0	18,095.13
SG&A	670.57	.24	29.07	97.69	340.75	104,736.00	2698.20
SG&A/sales	.28	.00	.14	.24	.38	1.00	.19
Control variables							
Employee intensity	.0060	.0001	.0027	.0044	.0069	.0577	.0061
Asset intensity	1.2028	.2029	.6576	.9768	1.4590	7.2813	.8446
Successive decrease	.2588	0	0	0	1	1	.4380
Stock performance	.0126	−.1329	−.0118	.0115	.0349	.2072	.0450
Total debt to sales	.7860	0	1	1	1	1	.4102
Agency remedies							
Payout							
Dividends (all firms)	70.45	0	0	0	5.03	14.96	462.86
Share repurchases (all firms)	90.86	0	0	0	7.13	35.73	662.54
Repurchases (firms that pay dividends)	71.74	0	0	0	0	35.73	642.08
Repurchases (firms that do not pay dividends)	19.12	0	0	0	0	10.44	171.57
Dividends (firms that repurchase shares)	52.33	0	0	0	0	13.00	409.45
Dividends (firms that do not repurchase shares)	18.12	0	0	0	0	14.96	220.21
EIndex	2.532	0	2	3	3	6	1.305
Agency remedies (as a percentage of sales)							
Rep(NDiv)	.0100	.000	.000	.000	.000	.3128	.0333
Rep(Div)	.0064	.000	.000	.000	.000	.2103	.0216
Div(Nrep)	.0032	.000	.000	.000	.000	.1723	.0136
Div(Rep)	.0044	.000	.000	.000	.000	.1197	.0129
Total payout	.0108	.000	.000	.000	.000	.2885	.0309

This table displays descriptive statistics for the sample that extends from 1998 to 2017. The first three rows present sales, SG&A costs, and the ratio of SG&A to sales. Employee intensity is the number of employees scaled by sales, asset intensity is total assets scaled by sales, successive decrease is a dummy variable equal to 1, if the prior year's sales are lower than 2 years prior, stock performance is the raw annual return for the firm in the prior year from CRSP. EIndex is the number of up to six antitakeover provisions adapted from Bebchuk et al. (2009). Variable descriptions are shown in Appendix A. For continuous variables, extreme observations in the top and bottom .5% of the sample are eliminated.

**TABLE 4** SG&A cost asymmetry, share repurchases, and dividends

Variable	Exp. sign	Model 1		Model 2	
		Est.	P-value	Est.	P-value
Intercept		.015	.000***	.015	.000***
Sales change		.739	.000***	.739	.000***
DecDummyXSalesChg		−.071	.020**	−.071	.020**
Interaction terms: (VariableXDecDummyXSalesChg)					
Employee intensity		15.505	.000***	15.491	.000***
Asset intensity		−.043	.006***	−.043	.005***
Successive decrease		.005	.807	.005	.808
Stock performance		−.085	.694	−.085	.693
Debt to sales		.252	.000***	.252	.000***
Dividends	+	3.077	.009***		
Div(Nrep)	+			3.266	.037**
Div(Rep)	+			2.697	.066*
Rep(NDiv)	+	3.184	.000***	3.185	.000***
Rep(Div)	+	5.336	.000***	5.481	.000***
Standalone variables		Yes		Yes	
Year effects		Yes		Yes	
Obs.		41,832		41,832	
R-squared		.616		.616	

This table displays the results of OLS regression with clustered errors. The dependent variable, SG&A cost asymmetry, is measured by the log of SG&A costs in the current period divided by the prior period. The model applied is Equation (1), where Sales Change is the log of the ratio of sales in the current period divided by the prior period sales, DecDummy is a dummy variable equal to 1, if the sales in the prior year are lower than sales 2 years prior. Employee Intensity is the number of employees scaled by sales, Asset Intensity is total assets scaled by sales, Successive Decrease is a dummy variable equal to 1, if the prior year's sales are lower than 2 years prior, Stock Performance is the raw annual return for the firm in the prior year from CRSP, Debt to Sales is long-term debt scaled by current year sales. Rep(Div)[Rep(NDiv)] is the amount of repurchases for firms that do[do not] pay dividends. Div(Rep)[Div(NRep)] is the amount of dividends paid for firms that do[do not] repurchase shares. Dividends are the amount of dividends paid, whether the firm repurchases shares or not. Standalone variables for the interaction terms are included but not displayed. Models include year dummies for all years. Significance at .10, .05, and .01 is denoted by \*, \*\*, and \*\*\*, respectively.

supporting that dividend payout is associated with less SG&A cost stickiness.

Similar to the results in Model 1, share repurchase in Table 4, Model 2, whether for dividend paying firms or not, is positive and therefore associated with reduced SG&A cost stickiness, and the finding is highly significant.

In summary, the results in Table 4, Model 1 and Model 2 for share repurchase and dividend payout support H1 and H2, that firms with higher payout policy have less SG&A cost stickiness, and the firms more effectively reduce SG&A expenses when sales decline. Said another way, higher payout policy is associated with tighter managerial control over SG&A expenses when sales decline. For firms that already pay a dividend, Rep(Div), share repurchases are associated with a highly significant incremental reduction in sticky SG&A costs beyond the effect of dividends.

Table 5 presents the regression results when the sample is divided between firms with strong versus weak governance.

Looking first at dividend payout, in Table 5, Model 1, dividend payout (Dividends) is significant (95% confidence) in

reducing SG&A cost stickiness in firms with strong governance. For the sample of firms with weak governance, dividend payout is not significant in reducing SG&A cost stickiness. This suggests that when dividend payout is the outcome of strong governance, it improves cost controls over SG&A expenses, supporting H3a.

In Model 2, dividend payout is separated by firms that do not repurchase shares, Div(NRep), and those that do, Div(Rep). In the sample of firms with strong governance, dividend payout is weakly significant in reducing sticky SG&A costs for dividend payers that also repurchase shares, Div(Rep). Dividend payout is not significant for firms that only pay dividends, Div(NRep). In the weak governance sample, dividend payout does not reduce cost stickiness. This finding is consistent with Jensen's (1986) article that firms with strong governance use periodic payout of dividends to limit cash flows available to management and reduce excess spending on perquisites. Hypothesis 3a is supported in Models 1 and 2, however, dividends in firms that do not also repurchase shares are not significant in reducing sticky SG&A costs.



TABLE 5 SG&A cost asymmetry for strong versus weak governance

Variable	Exp. sign	Model 1				Model 2			
		Strong governance		Weak governance		Strong governance		Weak governance	
		Est.	P-value	Est.	P-value	Est.	P-value	Est.	P-value
Intercept		.015	.033***	.022	.000***	.015	.029**	.022	.000***
Sales change		.768	.000***	.675	.000***	.768	.000***	.674	.000***
DecDummyXSalesChg		.023	.790	−.083	.235	.024	.780	−.084	.231
Interaction terms: (VariableXDec-DummyXSalesChg)									
Employee intensity		15.847	.020**	15.625	.009***	15.795	.020**	15.996	.006***
Asset intensity		−.142	.000***	−.121	.000***	−.142	.000***	−.121	.000***
Successive decrease		.049	.360	.040	.427	.049	.360	.042	.401
Stock performance		.420	.557	.668	.215	.418	.560	.668	.214
DebttoSales		.306	.002***	.455	.000***	.307	.002***	.456	.000***
Dividends	+	8.105	.024**	.599	.719				
Div(NRep)	+					8.342	.128	−1.000	.653
Div(Rep)	+					7.732	.051*	2.492	.262
Rep(NDiv)	+	2.501	.064*	4.636	.001***	2.501	.064*	4.612	.001***
Rep(Div)	+	1.654	.512	8.919	.000***	1.786	.517	7.724	.000***
Standalone variables		Yes		Yes		Yes		Yes	
Year effects		Yes		Yes		Yes		Yes	
Obs.		8370		6849		8370		6849	
R-squared		.627		.571		.627		.572	

This table displays the results of OLS regression with clustered errors. The dependent variable, SG&A cost asymmetry, is measured by the log of SG&A costs in the current period divided by the prior period. The Strong Governance sample has an EIndex (Bebchuk et al., 2009) of 3 or less, and the Weak Governance sample has an EIndex of 4 or higher. The model applied is Equation (1), where Sales Change is the log of the ratio of sales in the current period divided by the prior period sales, DecDummy is a dummy variable equal to 1, if the sales in the prior year are lower than sales 2 years prior. Employee Intensity is the number of employees scaled by sales, Asset Intensity is total assets scaled by sales, Successive Decrease is a dummy variable equal to 1, if the prior year's sales are lower than 2 years prior, Stock Performance is the raw annual return for the firm in the prior year from CRSP, DebttoSales is long-term debt scaled by current year sales. Rep(Div)/Rep(NDiv)] is the amount of repurchases for firms that do[do not] pay dividends. Div(Rep)/Div(NRep)] is the amount of dividends paid for firms that do[do not] repurchase shares. Dividends are the amount of dividends paid, whether the firm repurchases shares or not. Standalone variables for the interaction terms are included but not displayed. Models include year dummies for all years. Significance at .10, .05, and .01 is denoted by \*, \*\*, and \*\*\*, respectively.

Turning to share repurchases, payout policy using share repurchases is also examined in Table 5, Models 1 and 2 for separate samples of firms with strong and weak governance. Hypothesis H3b, related to improving EPS in periods of lower sales, states that share repurchase is associated with less sticky SG&A costs in firms with weak governance. Hypothesis H3c, related to agency theory, states that share repurchase is associated with less sticky SG&A costs in firms with strong governance.

In Model 1, for firms with strong governance, share repurchases reduce SG&A cost stickiness in non-dividend paying firms, the result being weakly significant at the 10%

level, supporting H3c. This finding is consistent with the example of Apple shareholders extracting payout through share repurchases, yet the significance for the sample of firms is weak. Share repurchases in dividend paying firms are not significant in reducing SG&A cost stickiness in strong governance firms.

In Model 1, for the sample of weak governance firms, share repurchases are highly significant in reducing sticky SG&A costs, whether the firm pays dividends or not, supporting H3b (Share Repurchase–EPS).

In Model 2 for firms with strong governance, share repurchase is weakly significant only for non-dividend

paying firms that repurchase shares, Rep(NDiv), weakly supporting H3c. Share repurchase in firms that also pay dividends is not significantly associated with reduced SG&A cost stickiness in strong governance firms, not supporting H3c. However, in the weak governance sample of Model 2, share repurchase is highly significant in reducing SG&A cost stickiness, whether the firm also pays dividends or not. Thus H3b, share repurchase to improve EPS, is supported.

Share repurchase can reduce SG&A cost stickiness by strong governance reducing agency problems or by management using share repurchases to improve EPS. The regression results identify weak support in both models for share repurchase as an agency remedy, but only for firms that do not pay dividends. On the other hand, share repurchase is highly significant in reducing sticky SG&A costs for firms with weak governance. This finding is consistent with management reducing SG&A expenses to improve EPS and to fund share repurchases that further improve EPS. Share repurchase is highly significant for firms with weak governance, suggesting that more entrenched management use share repurchase to improve EPS.

## 5 | CONCLUSION

This study examines the relationship between payout policy and asymmetric SG&A expenses for firms that have reduced sales. The effects of dividend payout, share repurchases, and the combination of payout with dividends and share repurchase. The findings indicate that higher payout, whether from dividends or share repurchases, is associated with less sticky SG&A costs. For firms that already pay a dividend, share repurchases are associated with an incremental reduction in sticky SG&A costs beyond the effect of dividends. Firms that pay dividends have less sticky SG&A costs. However, for firms that pay dividends and also repurchase shares, the coefficient on dividend payout is weakly significant, while the coefficient on the additional payout with share repurchases is highly significant, suggesting that the reduction in SG&A cost stickiness is influenced by the incremental share repurchases for these firms.

To examine the effects of governance, the sample is divided by firms with strong versus weak governance. Dividend payout is significant in reducing sticky SG&A costs only in the strong governance sample. This finding is consistent with La Porta et al.'s (2000) outcome model which states that dividends are the outcome of strong shareholders extracting payout and Jensen's (1986) agency theory that consistent payout provides improves management's overspending.

Share repurchase is highly significant in reducing sticky SG&A costs in the weak governance sample, and when

share repurchase is the only form of payout, it is weakly significant under strong governance. Share repurchase in strong governance firms follows the same agency explanation as for dividends, consistent with prior literature that identifies share repurchases as a means of controlling agency problems. Share repurchases are highly significant in reducing sticky SG&A costs under weak governance. This supports the argument that in times of declining sales, management with weak oversight uses share repurchase to improve EPS. The near term strategy to affect EPS for the purpose of meeting analyst expectations may not produce the highest value for shareholders in the long run.

This study is the first to examine the effects of payout policy on managerial perquisites contained in SG&A expenses. Dividends are expected to reduce management overspending because they are an ongoing commitment to pay a portion of cash flows to shareholders, and the findings in this study support that argument. Although share repurchases are more flexible, there is still weak support that non-dividend paying firms reduce overspending in SG&A when firms with strong governance payout excess cash via share repurchase. Firms with weak governance have reduced SG&A cost stickiness with share repurchase, but the relationship is consistent with management using the payout policy for short term performance recognition. Further studies on the relationship between sticky SG&A costs are warranted, especially for subsets of firms that just meet EPS targets or that have EPS just above zero.

### 5.1 | Limitations and opportunities for future research

A limitation of this study is that the methods identify an association but not necessarily causality between payout policy and sticky SG&A costs. Governance data (EIndex) is only available for S&P 1500 firms, which creates a potential bias by eliminating smaller firms from the governance sample analysis. Additional research is warranted to investigate the relationship between weak governance and share repurchases to improve EPS.

## NOTES

<sup>1</sup> He et al. (2020) examined whether firms with "higher resource adjustment costs (a variable combining total costs that include SG&A expenses)" pay less in dividends and total payout. They found that firms with stickier total costs pay less in dividends, but no relationship was found for share repurchases. He et al.'s (2020) study addresses a different research question and is distinguished from the current study in three ways. First, He et al. (2020) included all costs, as opposed to specifically considering SG&A cost stickiness, which is fundamental to the current research question. The inclusion of cost of goods sold in total sticky costs has the potential to interfere with the relationship between payout policy and

excess SG&A spending, especially because in some industries, cost of goods is a larger component of total costs than SG&A. Second, He et al. (2020) do not segregate payout for firms that pay only dividends, only repurchases, or payout in excess of committed dividend policy, which is important for determining whether and how payout policy methods address the agency problem as predicted by Jensen (1986). Third, He et al.'s (2020) study does not examine the effects of governance.

<sup>2</sup> Following Anderson et al. (2003), financial and utility firms are not eliminated.

<sup>3</sup> Dividends are obtained from Compustat variable DVC. Share repurchases are calculated using the following variables from Compustat:  $REPURCHASE = PRSTKC + (PSTKRV - PSTKRVMT1)$ , which is the purchase of common and preferred stock minus the reduction (if any) in the value of the net preferred stock outstanding (Bliss et al. 2015). The purchase of common and preferred stock (PRSTKC) minus any reduction in the value of net number of preferred stocks outstanding (PSTKRV).

## DATA AVAILABILITY STATEMENT

Data subject to third party restrictions. (More specifically, Compustat and Institutional Shareholder Services.)

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