Adjustment Costs: The Unrecorded Costs Behind Organizational Adaptation and Inertia

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* Corresponding Author. We are grateful to Carolyn Deller for research assistance, the AICPA for sponsoring our survey research and to the Australian Research Council for funding for the field research and related project expenses. We are also grateful to the companies that participated in the field study and to the managers who shared their time and expertise with us.
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Abstract

Adjustment costs, typically a parameter in production economics models, are central to understanding firms’ adaptation or inertia to changes in external input and output markets. In this paper, we argue that accounting research, which aims to build theories of the design and use of cost accounting data by managers, is not well-served by treating adjustment costs as a simple parameter in a cost function. We posit that discriminating the source and form of adjustment costs is essential to developing theory about whether and how managers respond to changes in external circumstances - responses that leave their trace in cost accounting and operational performance data. We theorise the sources and forms of adjustment costs from several literatures. We start with the simple adjustment cost model of production economics which conceptualizes adjustment costs as the costs of frictions experienced in changing from one equilibrium, state to another. We then compromise the assumptions of the economic model and draw on theories from behavioral economics and organization behavior to introduce adjustment frictions arising from attributes of organizational architecture. Finally we draw on psychology theories to introduce adjustment frictions attributable to ‘predictably irrational’ managers. We draw on field research and a mail survey to gain empirical insight into managers’ experience of adjustment to exogenous shocks and to assess the extent to which the theories we draw on conceptualize this empirical experience. The data provide evidence on the presence and form of adjustment costs, the degree to which adjustment costs are a barrier to adapting to changed market circumstances, and the association between adjustment costs and the costs that are targeted for management as well as the analysis tools that are most commonly used during periods of adjustment. We conclude by proposing a typology of adjustment costs; a construct that we view as essential to any analysis of cost systems and cost management during the last, turbulent decade.