Reducing budget slack may lead managers to focus on the short term

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Every time I see corporate accounting irregularities in the news I recall how a key finding in my doctoral research some time ago has remained relevant. The research showed support for a spillover effect between slack resources and managerial time horizon. Kind of like a 'whack-a-mole' effect. Slack refers to securing more resources (such as during an organization's annual budgeting process) than are strictly necessary. The research suggested that trying to reduce slack may rear its head elsewhere; that is, in the form of greater myopic decision making.

But there were also two other factors (and inevitably many others, but unmeasured ones) in play: past performance and competitive strategy. The results indicated that businesses that either pursue a differentiation strategy or have been more profitable tend to be subject to looser controls, which was associated with more slack as well as a greater tendency for managers to think long-term.

This suggest an interesting tension. When does the comfort of good performance and success become so comfortable that it squanders resources or erodes the firm's competitive edge, but equally, when does cutting any slack become so constraining that it erodes the necessary long-term orientation for sustainable competitive viability?

Tight budgets, slack and myopia

A tight budget-control style is one in which managers are evaluated primarily on whether or not they achieve their budget, usually expressed in terms of a profit target. When evaluated in this way, managers are held fully accountable for their performance as measured by the budget. This implies that salary, resources and career prospects become highly, if not fully, dependent on the managers' ability to meet the budget. Managers who miss their target face the prospect of interventions by their senior management, the loss of organizational resources, the loss of bonuses, and ultimately the loss of their job. Under such pressure, managers may look for ways to protect themselves from the downside of missing budget targets by way of, for example, negotiating more achievable targets (ie, 'padding the budget' or 'slack creation') or by focusing on business matters that improve current period performance even if possibly harmful long-term for the business (ie, 'myopia' or short-term managerial orientation).

It is important to emphasize, however, that one must be careful to consign slack and decisions that improve short-term performance as unequivocally 'dysfunctional' or 'bad'. Not all cuts are 'myopic', nor is all 'slack' a waste. Slack sometimes has beneficial effects (eg, to pursue strategies that require innovation and experimentation) and some seemingly short-term management decisions can help both short-term and long-term results (eg, scrapping projects with dubious fortunes that 'cut the loss' rather than jeopardize competitiveness).

To add complication, cutting slack can be good (when the extra resources indicate inefficiencies or 'empire building'), but not always (when the slack allows experimentation and provides some wiggle room for innovation and flexible responses and agility). Equally, cutting R&D is not always 'bad'—it is only 'myopic' when it is done to boost short-term earnings while shortchanging long-term value, but when it rids the firm of dud projects, it is good in both the short and long term. But the important result in my study was that I found slack and managerial short-term orientation to be negatively related, indicating that when slack was reduced, managers tended to be more short-term oriented.

Importantly, past performance appeared not to be an innocent bystander: business units that were more profitable enjoyed looser controls, which provided more leeway for slack creation which, in turn, tended to reduce the pressure for short-term results. A virtuous circle, until of course there is "not enough" pressure.

But it is the vicious circle of "too much" pressure that can be more easily imagined, although it is usually not spotted until it is too late. This has been shown in a string of scandals in Japanese corporations of late that have been attributed to "overly aggressive targets".

Let's focus on one of these scandal-ridden cases, Toshiba, where CEO Hisao Tanaka stepped down in late July after an inquiry uncovered that the company had inflated its profits in one of Japan's biggest accounting scandals. But for my purposes, it is the following that is intriguing. As the FT reported: while Mr Tanaka may not have given subordinates instructions to cook the books, it seemingly was the firm's culture spanning three generations of chief executives to "exert pressure on employees to meet aggressive, short-term profit targets," where the "top-down pressure to meet increasingly unrealistic targets escalated as earnings deteriorated in the wake of the global financial crisis and the 2011 earthquake and Fukushima nuclear accident."

This suggests pressure all around, from deteriorating past performance and from higher up — no slack and no wiggle room, and much else besides (such as weak corporate governance and a deferential organizational culture). How much can one squeeze? Clearly there is a limit where cutting slack, finding inefficiencies or profits to report turns into cooking the books – hardly good decision making and certainly not viable long-term.

To provide another context as an illustration of the tension, private equity can also have the good effect of cutting slack — to hold executives' feet to the fire to 'sweat assets'. But the trick is to keep those feet close enough, yet not so close that those holding their feet to the fire end up burning their fingers.

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Notes:

- *This post is based on the author's PhD dissertation, "The relationship between two consequences of budgetary controls: budgetary slack creation and managerial short-term orientation," in Accounting, Organizations and Society, 25(6) 2000, 609-622.*
- *The post gives the views of its authors, not the position of LSE Business Review or the London School of Economics.*
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