

# Budgetary slack as a management control mechanism accounting essay



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## **Introduction**

Budgeting control system is one of the popular mechanisms in the management control systems that have undergone significant shifts of emphasis in both literature and practices. Budget slack meaning a deliberate underestimation of revenues and overestimation of costs than of actual budget is one of the aspects of budgetary control in the research of contemporary accounting management literature. The conventional wisdom on budgetary slack underlies a negative image of slack creation by the managers to appropriate organizational resources available after optimal utilization of the so called achievable budget targets. Alternative voice is that budgetary slack is often rewarding for the managers and also for the organization, serving as motivation for efficient utilization of resources and meeting the targets of the organization. However, the relationship between budgetary slack and management control mechanism underlies budgetary slack as the outcome of either tight budgeting or lack of budgetary

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supervision. In addition to that, budgetary slack are also used as management control mechanism.

Against this backdrop, the objective of the paper is to review the existing image and practices of budgetary slack as a mechanism of management control and the role of budgetary slack that impact on the behavior of managers. For that end the paper in the beginning details out the conceptual scheme of budgetary slack and the factors and strategies to create budgetary slack. It reviews the linkages between management control mechanism and budgetary slack in the next section. Then, the paper importantly deals with the role of budgetary slack on the behavioral pattern of the managers. Finally the paper ended with discussing some ways to enhance the positive functioning of budgetary slack to control unethical practices and increase accountability and transparency of the management.

## **The Concept of Budgetary Slack**

Budgetary slack in its simplest form, as in the lexicon of advance accounting, is defined as the difference between an actual budget figure and an easily obtainable budget figure. When a manager controls budget resources more than optimal to accomplish his or her objectives, then the manager creates a condition of budget slack (Kren, 2003). For instance, budget slacking may take the form of underestimated performance capabilities, understated revenues or overstated expenses over a projected period of time. The official terminology of CIMA considers that slack in the budgeting process occurs if there is an intentional underestimation of revenues or overestimation of expenses by the managers (Jia, 2007). Payes (1989) emphasizes on the issue of performance in defining budget slack. According to his perspective, the <https://assignbuster.com/budgetary-slack-as-a-management-control-mechanism-accounting-essay/>

difference between a division's expected performance capability and a participatively-set performance standard or target creates budgetary slack. Budget slack is the difference between the resources allocated or available to a division and those resources needed to achieve a budget-set or output target. Becker and Green (1962) and Schiif and Lewin (1970) advocated that for slack to occur participative budgeting is a necessary condition.

Budget slack should be distinguished from two related concepts in the accounting management literature: 'organizational slack', and 'budget achievability'. Organizational slack which serves as a positive function by absorbing fluctuations in an uncertain environment refers to the safeguard measures taken by the authorities to reduce the harmful effects of uncertain conditions on which the firms function (Cyert and March, 1963). Quite similarly, 'budget achievability' reduces the risk of dysfunctional subordinate behavior by increasing predictability of earnings, and reducing time spent on control of profit center operations (Merchant and Manzoni, 1989). The differences between budget slack and these two concepts is that budget slack is concealed from superiors and exceeds allowable levels. Other views on the definition of budget slack are mostly concerned with managers' effort to choose a more easily attainable budget standard against which subordinates' performances will be evaluated (Jawarski and Young, 1989), or with managers' desire to create protection from uncertainties by absorbing fluctuations (Cyert and March, 1963).

## **Creation of Slacks: Influencing Factors**

The creation of budget slack is a complicated process that involves

managerial agents pursuing diverse motives and creates many opposing

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consequences. Slack usually is the result of the self-interested behavior of unit managers, but can be created by anyone who prepares the budget (Onsi, 1973). Schiff & Lewin (1970) think that in addition to participation, slacker should have information advantage. When the top management placed heavy pressure upon lower level managers who prepare budget, they create slack to make the budget look achievable so that they can avoid the burden of failure. Less monitoring from the top management on the budget making process give lower level managers leverage to plan budget slacking. Bitner (2005) found that the larger the entity the more likely budgetary slack will exist, since a larger entity faces the difficulty in involving everyone in the budgetary process. Budget slacks are created to deliberately lower targets than the best guess forecast about the future either by overstating cost forecasts or understating revenue forecasts. This is most known type of slack occurs in many organizations in both early and contemporary practices of slacking. More recent practice of slack occurs when scarce resources are allocated to managerial units based on negotiated goals, since managers can justify their claim to more resources if negotiate achievable and optimistic targets.

Kren (2003) provided a comprehensive assessment on the factors that influence the creation of budgetary slack. He identified an ex-ante as well as an ex-post process by which budget slack. In the ex-ante process, he linked budget participation and environmental uncertainty to managers' propensity to create slack. On the other hand in the ex-post process, if organization's control system fails to provide an effective assessment of the manager's performance capability, slack will be created. From the findings of

accounting management researches, the major factors influencing the creation of budget slack are the self interest motives of the lower level managers, information asymmetry between top level management and unit managers, uncertainty and unpredictability of the condition under which firms function, participative method of budgeting allowing vacuum of monitoring and control, inappropriate use of performance measures and so on.

The first thing that influences the creation of budgetary slack is the control problem which arises with managers using their private information to make decision conforming with self-interest instead of the bigger targets of the organization. Managers want to look successful in terms of budgetary performance by creating a lower performance benchmark relative to their actual capabilities to receive favorable evaluation and reputation in the top management. The second important factor is the information asymmetry that forms a favorable condition for slack creation. Information asymmetry occurs with Managers acquiring more private information because they are closer to the decision environment than their superiors (Kren, 2003).

Preventing the disclosure of all the information to the top management, Managers present a distorted picture of business possibilities to their superiors and create budget slack (Langevin, 2010).

A third factor in the creation of budget slack is the uncertainty caused by some adverse variances inevitably linked with properly set budget (Jia, 2011). Managers want to use such slack as a cushion for uncontrollable or unpredictable events like machine malfunctions or breakdowns, worker attrition etc likely to be occurred in future. Young (1985) and Kren and Liao  
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(1988) all found the level of uncertainties affecting outcomes in the organization influence the extent to which participation can affect the propensity to create slack. A primary driver for the existence of budgetary slack, as management accounting perspective claims, is uncertainty (Marginson and Ogden, 2005).

Participative method of budgeting that allows a bottom up approach in budgeting process is another important factor in the creation of slack. In the participative method, budgetary slacks could occur and the organization could get disoriented if solely set by subordinates. Though many researchers have found that participation reduces the likelihood of slack by affecting individuals' satisfaction, motivation, performance and job attitudes, the possibility of budgetary slack creation in the participative method have been confirmed by many researchers (Young, 1985; Lukka, 1988). Dysfunctional budgetary behavior particularly increased propensity to create slack is also influenced by the inappropriate use of performance measures in the evaluation system. A higher level of job related tension and dysfunctional decision making is evoked by budget-constrained evaluation system and budget-based performance requirements (Baiman and Lewis, 1989).

## **Management Control System and Budgetary Slack**

Management control mechanism underlies strategies employed by a Management Control System (MCS). In order to evaluate the performance of the organizational resources like human, physical and financial, MCS is used for collecting and using information so as to influence the implementation of organizational strategies. MCS is defined as the process applied by the

managers to ensure effective accomplishment of the organization's  
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objectives by utilizing efficient management of available resources (Armash, 2010). Managers use devices and systems of MCS to keep the decisions and behaviors of employee consistent with the overall objectives of the organization. MCS is a comprehensive system in which management accounting system is a part that deals with measurements and outputs of the performances by means of administrative controls. Budgeting process is one of the traditional management control systems used to measure internal performance.

Budgetary control is one of the key aspects of management control system. In the overall stack of control, budgeting plays an important role in allocating resources, aiding efficient utilization of available resources, motivating employees, evaluating performances and keeping the consistency of work with objectives of the organization. Budgetary control is a combination of motivation, planning, coordination and controlling by means of setting targets and offering rewards for a definite period of time usually one year. The essence of budgetary control is a part of behavioral management by setting agreed performance standards and controlling the attainment of those standards. In contrary to such positive reflection, Otley (2007) considers budgeting as a very limited management tool, as it is made of rigid standards by tying performance bonuses to budget achievement. Since budgeting cannot address uncertainty and put emphasis on performance and achievability, budgetary control may result into budget slack, one common problem in the budget-setting process.

The conventional wisdom on the budget slack resulting from budgetary controlling is that slack is the outcome of tight budgetary control. In the <https://assignbuster.com/budgetary-slack-as-a-management-control-mechanism-accounting-essay/>



uncertain environment, managers often plan for achievable standards, since it often brings about rewards both pecuniary and non-pecuniary for the subordinates. Many behavioral priors in the accounting management research found that rigid budgetary control could induce budget slack. This is because in the rigid budgetary control, as the evaluation of managers performance is conducted based on the degree of budget achievement and hence salary, resources, and career prospects of managers become highly dependent on the managers' ability to meet the budget. Managers respond to the downside risk of missing budget targets and stigma by creating slack, making targets highly achievable (Lukka, 1988).

Unlike the behavioral priors, Hopwood (1972) and Otley (1978) found mixed result budgetary controls and dysfunctional behaviors. On the other hand, organization economists, with empirical findings, suggest an opposing view on the relationship between tight budgeting and budget slack. According to their claims tight budgeting led to more efficient scrutiny over any dysfunctional outcomes such as slacking and ensured higher budget accuracy. A high emphasis on budgetary control and a rigid budgetary environment was more likely to detect and avoid dysfunctional behavior and hence led to low budget slack (Dunk, 1993). To mediate this puzzle, Otley (1978) pointed the issues like context, organization's operating environment and size, past performance record and so on that act to define whether tight budgetary control results onto budget slack or not.

Another relationship between budgetary management control and budget slack is the degree of participation in the budgeting process. In literature revolving around participation and budget slack, are two opposing views: it is <https://assignbuster.com/budgetary-slack-as-a-management-control-mechanism-accounting-essay/>

to reduce the incidence of slack or to add to the opportunities to create it (Dunk and Perera, 1997). Participation makes it difficult to involve everyone in the budgeting and therefore allows information asymmetry and scope for managers to create slack. On the other it also makes managers accountable to many participants and therefore makes it difficult for them to conceal the actual state of budget. The relationship between slack and participation is not a simple one but may be dependent on many issues such as budget setting, extent to which information can be manipulated and evaluative styles.

However, the relationship between budgetary slack and management control mechanism underlies budgetary slack as the outcome of either tight budgeting or lack of budgetary supervision. In addition to that, budgetary slack are often used as management control mechanism. Since budget slack is based on the earning performance-dependent rewards, slack can serve as motivation for efficient utilization of resources and meeting the targets of the organization. It can enhance the image of the organization to the outsiders as being efficient in the projection of the organization's ability to fulfill its objectives. As a control mechanism, budgetary slack creates a reward structure which provides an incentive for managers to select accounting procedures and accruals to increase the present value of their rewards. It also provides mechanism to hide uncertain and unpredicted expenses.

### **Role of Budget Slacks Affecting on Managers' Behavior**

In the budgeting management control, managers particularly from unit level heads pursue key responsibilities in preparing budget and ensuring the

consistency of the subordinates' activities and performances with the budget  
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targets. Often the evaluations of the managers' performances are done against the achievement of the budgetary targets. Managers are more likely to see themselves as "winners" whose unit achieves its budgeted goals (Merchant and Mazoni, 1989). In exchange, they receive material rewards, such as bonuses based on the standard of their performances. Hence, budgeting influences managers' attitudes and behaviors heavily. The seminal work of Argyris (1952) and many other empirical researchers have found that in addition to positive influences, budgetary control affects the dysfunctional behavior of the managers such as budget slack. In the aspect of budgetary control's influence on the managers' behavior, budgetary slack is a usual case. Major aspects of budget slack that affect the behavior of the managers are furnished below:

**Self-satisfying Motive and Achievable Performance Targets:** One of the important roles of budgetary slack on managers behavior is the managers' strive to satisfy individual and subgroup objectives. Merchant and Van der Stede (2007) observed that the opportunities for overstating costs or understating revenues is in the advantage of managers by giving them chances to obtain non-monetary and monetary rewards from more readily achievable performance targets. This indicates that the motivation of the managers to create budgetary slack is foremost aspect of impact of budgetary slack on managers' behavior. Lukka (1988) in his empirical study found three different motives of the managers in creating slack: (1) resource intention meaning to appropriate resources that exceed the optimal allocated resources; (2) motivation intention meaning to motivate the subordinate to improve their performance; and (3) performance evaluation

intention meaning to increase the probability of a favorable evaluation by setting low budget-based output targets. These three motives often make managers play dysfunctional role affecting the overall success of the organization.

Beneficial Prospect of Budget Slacking: Managers' attitude to the budget slacking as something beneficial either for their own interest or professionally for the improvement of the organizational output ratio is another issue of budget slack's role affecting managerial behavior. Managers in many cases perceive to make their performance look better to their superiors when a low ambitious budget target is met. This attitude increases a supportive role of slack in enhancing managers' acceptability to the top level management. Since budget slack protects business unit managers against unforeseen contingencies help to enjoy a favorable evaluation by meeting the targets and prevent interventions by upper management, (Stede, 2000) managers try to create slack. But the beneficiary outlook of slack does not work to affect managers all the time. Many of the unit managers are enlightened otherwise by accepting the fact that slack budgets can lead to lower firm returns from suboptimal resource allocation decisions, because they hinder full disclosure of private information and coordination of business unit activities (Onsi, 1973). Managers in these cases are act from organizational perspective and avoid creating slacks.

Organization's Control System and Managers under Compulsion: Most of the researches focused on the managers' interest in creating slack. But in many cases, it is the organization's control system that compels unit managers to create slack by forcing them to misreport actual budget. Young (1985) found <https://assignbuster.com/budgetary-slack-as-a-management-control-mechanism-accounting-essay/>

that organization's control system can easily uncover slack and allow unit managers to report with slack in budget. Sometimes this serves as a win-win case between top management and the managers, affecting managers' behavior favorable to slack creation. The issue of monitoring is also relevant here. If top management eases up the monitoring control, it structurally gives managers signals and also scopes to create slack. In many cases, a fraction of the top management can be involved in maximizing sub group interest and reduce a fair distribution of the outcomes among all the shareholders. Many agency theory-based experiments found that when managers are given opportunity, manager's tendency to create slack increases more (Waller and Bishop, 1990).

**Contractual Arrangements and Conflicting Objectives:** Creation of budgetary slack is not a unified thing. In the course of creating slack and realizing self-interest behavior led to conflicting objectives among the group involved in the slacking process. Since the organization in general and budgetary control in particular are forms of contractual arrangements and there exist an agency relationship between authorities and their subordinates based on some principles, agents will not always act in the best interest of the principal. Realization of self-interest by the subordinates, therefore, is not in the interest of the authorities. Creation of slack affects the contractual principles and thereby contractual relationships and creates division based on mistrust among each other (Jensen and Meckling, 1976).

**Fairness and Business Ethics in Managers' Behavior:** Slack affects the fairness and managerial ethics of the managers. Managers are prone to expropriate resources unnecessarily by reporting dishonestly during the <https://assignbuster.com/budgetary-slack-as-a-management-control-mechanism-accounting-essay/>

budgeting process. It is not in the best interests of the overall organization, that managers misappropriate resources and still get the reward from the top level. This reduces the level of honest behaviors among the employees both reporting and non-reporting. To explain such behaviors, researchers used 'Moral Disengagement Theory' that refers to a setting where managers can disengage moral responsibility from their action by self-justifying the action so as to make it compatible with moral standards (Bandura, 2002). This involves a condition that if there is a shared group interest in creating budget slacking, managers feel more "legitimate" self-justification and dishonestly provides more for misreporting. Here comes the issue of distributory ethics of managers in the post-slack period. If the benefit of slack is shared, other employees' awareness of the misreporting does not affect managers' behavior when because the misreporting can be self-justified by shared interest. On the other hand, if the benefit of slack is not shared such awareness increases reporting honesty of the managers.

## **Controlling Budgetary Slack**

Devising ways to control budgetary slack is an important research objective of management accounting researches. In the contemporary practices, more emphasis is given on the measures how to detect such dysfunctional behavior and curb its presence in the budgetary control mechanism. One issue supported by empirical studies is budgetary feedback and budgetary participation as a mechanism to reduce budgetary slack (Lu, 2007).

Distributive fairness and goal commitment in the budgetary participation also reduce the propensity to create budgetary slack. Accounting culture with accrual accounting will give managers less scope to pursue

dysfunctional behaviors (Bradshaw, 2007). Besides, the controlling of slack depends on the ability to set accurate budget targets and to measure performance precisely (Stede, 2000) Reputation of the superiors works as the informal control over the managers' propensity to create slack. Abdul-Rahman and Hailes (2000) supported that reputation is used to influence cooperative behaviours with agents and increase subordinates behavior to cooperate with them. Creation of alternative reward structure is also necessary to satisfy the best performers. The adoption of accuracy based evaluation system can also be helpful to motivate managers to comply with the bigger objectives of the organization.

## **Conclusion**

Budget slack involves underestimated performance capabilities, understated revenues or overstated expenses over a projected period of time. The established view on the budget slack resulting from budgetary controlling is that slack is the outcome of tight budgetary control. In the uncertain environment, managers often plan for achievable standards, since it often brings about rewards both pecuniary and non-pecuniary for the subordinates. The creation of budget slack is a complicated process that involves managerial agents pursuing diverse motive and creates many opposing consequences. Managers' attitude to the budget slacking is something beneficial either for their own interest or professionally for the improvement of the organizational output ratio. This attitude increases a supportive role of slack in enhancing managers' acceptability to the top level management. But the beneficiary outlook of slack does not work to affect managers all the time. Many of the unit managers are enlightened otherwise

by accepting the fact that slack budgets can lead to lower firm returns from suboptimal resource allocation decisions, because they hinder full disclosure of private information and coordination of business unit activities (Onsi, 1973). Managers in these cases are act from organizational perspective and avoid creating slacks. However, devising ways to control budgetary slack is an important research objective of accounting management researches. In the contemporary practices, more emphasis is given on the measures how to detect such dysfunctional behavior and curb its presence in the budgetary control mechanism.