

Budgetary Slack: Does it Hurt Organisations?

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Abstract

Budgetary slack is a common practice where managers deliberately underestimate revenue and overestimate expenses in their budgets to create a cushion. Budgetary slack, the intentional padding of budgets by managers, has long been recognized as a controversial practice in organizations. This article addresses the complex issue of budgetary slack in budgeting process, whether it could result in positive or negative impact on organization and employees' performances. The article identifies the various factors contributing to budgetary slack including high budget participation, information asymmetry, and high job insecurity, and the detrimental effects they can have on an allocation of resources, performance evaluation, accountability and innovation among employees. Additionally, the article explores the potential moderating factors, including performance measurement system, corporate governance, mechanism, and leadership, that could influence the relationship between the budgetary slack and its detrimental effects. These conclusions are based on a thorough review of recent research articles, which offer valuable insights into the various attributes of organizations as well as the impacts of budgetary slack.

Keywords: Budgetary Slack, Budget Participation, Information Asymmetry, Accountability And Leadership.

Introduction

Budgeting is one of the main pillars of any organization and management accounting, through which strategic planning, organizing, operations evaluation and employees' behavioural changes are possible (Fay and Patterson, 2018; McCrie, 2016). Managers actively involved or participated in budget preparations. Many previous studies have demonstrated that the manager's participation resulted in budgetary slack. Most of them, by utilizing agency theory (Baiman et al., 2000; Namazi, 1985) and psychological paradigms (Andre et al., 2016; Cheok et al., 2018; Hartmann and Maas, 2010; Young et al., 2021) have been focused on the manager's participation in budgeting and its effect on the use of budgetary slack (Macinati and Rizzo, 2014; Maiga and Jacobs, 2007; Merchant, 1985).

In general, the results reveal two contradicting views. First, is from the traditional view which considers budgetary slack as a negative and unethical phenomenon leading to organizational disorders such as reduced profit, transfer of rare assets between departments, unfair asset allocation, and abnormal human behaviour (Merchant, 1985). Secondly, is from the contemporary view which regards budgetary slack as a positive factor leading to enhanced organizational performance and risk management. Namazi and Rezaei (2023) showed that based on the agency theory, stewardship theory, and empire-building attitude of the public managers in the health sectors, management at all levels would increase the budgetary slack to attain the public interest. In addition, Rohma and Chamalinda (2023) show that budgetary slack allows the management to balance disparate goals and cope with changed external conditions. The results suggested that deliberately made budgetary slack, oriented toward long-term business development. As exhibited by the results, budgetary slack became the basis for budgeting through an assumption of a flexible cost scheme. Here, the cost budget target fulfilment was irrational when coping with non-financial orientation, namely product quality and going concerned. Management and regulators could take the roles of cost flexibility and conditional budgetary slack into account during the budgeting mechanism to spur goal congruency.

Budgetary slack refers to intentionally inflating the budgeted amount of a project or department to create a cushion or safety net. This cushion allows managers to have some room for error in case unexpected expenses or setbacks occur during the project or fiscal period (Horngren et al., 2015). Saarinen (2021); Ngo et al (2017) indicate that a high emphasis on budgets such as managers' performances by emphasizing the completion of budget targets, a characteristic of budget-based compensation schemes, as managers would lead to a high creation of budgetary slack by managers. Budgetary slack can be introduced for various reasons. One common reason is that managers may be afraid of being held accountable for not meeting the budgeted targets. By intentionally creating slack in the budget, they can ensure that they will meet or exceed their targets, thus avoiding negative consequences such as lower bonuses, reduced job security, or a tarnished reputation. Another reason for introducing budgetary slack is that managers may want to have access to extra resources that can be used for other projects or priorities. By inflating the budget, they can request more resources than they need and use the excess to pursue other goals. While budgetary slack can provide a sense of security and flexibility for managers, it can also have negative consequences for the organization. It could lead to inefficiencies and waste of resources (Mousa and Chowdhury, 2014). Therefore, organizations need to monitor and control the use of budgetary slack to ensure that it is used appropriately and does not become a regular practice. From an accounting perspective, budgetary slack has dangerous consequences for future profits or upcoming costs, harming the upper managers' resources because of the transfer to the middle-managers, and losing the upper managers' trust in the middle managers because of actions taken by middle managers

One of the common budgeting techniques used by organizations is participatory budgeting. Since 1989, participatory budgeting (PB) has been a democratic process in which community members directly decide how to spend part of a public budget. In management accounting, this is commonly known as participatory budgeting. Participative budgeting is a budgeting process in which people at the lower levels of management are involved in the budget preparation process. By involving the subordinate managers to coordinate the budget preparation process, it will benefit the company since these managers have better information about the running of their respective departments. However, one of the

consequences of practising this budgeting technique is budgetary slack. Santos et al (2022) reveal that budgetary slack is an inherent element of the budgetary process (budgetary participation), and Widanaputra and Mimba (2014) found that budgetary participation has an important influence on the cause of budgetary slack. The employees may overestimate the costs and/or underestimate the revenue projections as a way of manipulating the budget to their advantage (Hobson et al., 2011). It means that the subordinate managers will set targets that they are sure to achieve and even exceed in the next financial year. This mostly happens when the manager's performance is measured based on the attainment of the budget. By making the budget easy to achieve, the managers will be seen as exceeding their targets as a result, it is maximizing the rewards (Ginanti & Widanaputra, 2022).

Many studies found that employees' participation in budget preparation and the adequacy of the budget would cause budgetary slack, which in turn jeopardized accountability towards the budget. Nouri and Parker (1998); Minai and Pui Mun (2013) suggest that an inadequate budget will hinder performance achievement. However, Baerdemaeker & Bruggeman (2015) investigate the impact of participatory strategic planning on managers' creation of budgetary slack. The results suggest that increased participation in strategic planning can lead to lower budgetary slack creation through the suggested path of heightened affective organizational commitment and with controls for budget participation and slack detection.

Problem Statement

Budgeting is a management control mechanism, but some misuse of budgeting as a management control mechanism may occur through budgetary slack behaviour (Rohma, 2022). Mat et al (2022) suggest that participation in the budgeting process can improve budget performance. However, the effect is dependent on the adequacy of resources presented to participants. Nonetheless, it does not specify whether the budget's performance is devoid of budgetary slack. Anggraini et al (2023) discovered that budgetary participation has a substantial positive impact on budgetary slack.

Budgetary slack occurs when organizations underestimate revenues or overestimate expenses when preparing a budget to achieve the key performance indicator, thus allowing managers a much better chance of "making their numbers," which is particularly important for them if performance appraisals and bonuses are tied to the achievement of budgeted numbers. Budgetary slack can occur when middle managers deliberately lower their abilities, or their business units' capabilities to reach the target, when setting a budget target (Hobson et al., 2011). In addition, budgetary slack is also a ubiquitous practice between officials and organizations, even though it could create a dysfunctional organization (Mohd Sairazi et al., 2021). Additionally, managers of the marketing, development, and production departments frequently engage in these practices. They take these actions because of the pressure from upper managers to achieve budget goals to survive uncertainty (Davis et al., 2006).

However, budgetary slack is considered unethical because it does not follow the norms and traits desired by managers and professional accountants (Maiga and Jacobs, 2008). In addition, the budget targets set by middle managers can be detrimental to the company when they tend to deliberately reduce their efforts to achieve budgeted targets (Gago-Rodriguez & Naranjo-Gil, 2016). This action is also considered a budgetary slack action and is also considered unethical because it harms the company (Gago-Rodriguez & Naranjo-Gil, 2016). There are numerous debates nowadays on whether budgetary slack is beneficial to the company or detrimental. The budgetary slack can be harmful to an organization whereby it creates resource misallocation Azar et al (2016), effects of trust and distrust (high and low)

in the efforts of middle managers Gago-Rodríguez & Naranjo-Gil (2016), the maximum amount of budgetary slack possible given budget-related compensation Liessem (2015), the budget slack potentially exerts bias in the budgeting process, which is detrimental to the accountability of local authorities Mat et al (2022) and budgetary slack can impact organizational goals and performance (Yee & Khin, 2014; Yee et al., 2016).

In summary, while budgetary slack may seem like a helpful tool for managing uncertainty and meeting budget targets, it can ultimately be disadvantageous to an organization's financial health, transparency, innovation, employee morale, and overall performance. Therefore, it is crucial for organizations to carefully evaluate their budgeting processes and ensure that they are promoting accountability, transparency, and innovation, rather than encouraging budgetary slack. Besides, little attention has been given to situations that control the implementation of the proposed methods set in the budget, the effects of budgetary slacks and the role of people in organizations.

Literature Review

Slack with a positive effect

In some circumstances, especially when the activity significantly contributes to the organization's goals, the production of slack will boost the utility function, which is the accomplishment of organizational goals. The budgetary slack is not always harmful to the organization, according to (Azar et al., 2016). The results show that budgetary slack can accelerate goal achievement and improve the utility function of an organization by skewing allocation decisions in favour of the most beneficial activities. Directing the slack to the most strategic activities and preventing them from engaging in inappropriate activities, will help decision-makers and chief managers optimize their decisions about the allocation of resources. In other words, the activities that are most relevant in accomplishing organizational goals are those where the budgetary slack is most significant.

Also, the success of the firm and the relationship to be stronger in private firms are positively correlated with budgetary lack (Ju & Zhao, 2009). According to Terry Mousa and Chowdhury (2014), budgetary slack resources have an impact on commitment to innovation and are advantageous to R&D businesses. However, there may be an inverse U-relationship (curvilinear) between slack and innovation in companies if there is both too much and too little slack, which may be harmful to innovation. Moreover, Alessandri et al (2014) contend that financial tightness is what drives the expansion and diversification of cross-border acquisition. Also, it is in line with a different study by Dai & Kittilaksanawong (2014) that discovered human resource and financial slacks have both direct and indirect favourable benefits on a firm's future growth. It suggests that slack resources of all kinds are closely tied to business growth since they can provide services that support business growth. In addition, Gamayuni (2019) proves that participation in budgeting preparation, budgetary slack, authority delegation, and organizational commitment will increase the managerial performance of local government work units in the Lampung District or City.

Slack with a Negative Effect

Misallocation sources

Budgetary slack can cause misallocation of resources in an organization. Budgetary slack refers to the practice of intentionally overestimating expenses or underestimating revenues in a budget to create a cushion or surplus. This practice may be done to protect against uncertainty or to allow for flexibility in case of unexpected expenses. However, if budgetary

slack is used excessively, it can result in a misallocation of resources Terry Mousa and Chowdhury (2014). When a department or unit is given a budget with slack built in, it may not feel the need to make the most efficient use of its resources since it knows that there is room for error. This can lead to wasteful spending and the allocation of resources to projects or activities that are not the most valuable to the organization. Hobson et al (2011) explain that building in budgetary slack is an unethical action in companies when it is related to their suboptimal allocation of resources, where there is a misrepresentation of information within the company through the occurrence of slack. The behaviour of budgetary slack is a moral problem within the organizational decision-making process because it can lead to resource misallocation and inconsistency with role-related and professional norms. In addition, resource allocation becomes inefficient and can cause a bias in evaluating the performance of subordinates in their unit of responsibility (Deng et al, 2020). Therefore, while budgetary slack can provide some benefits, organizations need to use it judiciously and ensure that it does not lead to a misallocation of resources.

Dysfunctional Behaviour

Slack is a dysfunctional behaviour because it can undermine a company's long-term performance Libby & Lindsay (2010) and does not reflect individuals' real performance (Hartmann & Maas, 2010). Gago-Rodrguez & Naranjo-Gil (2016) provide an important point on the importance of extrinsic motivation for enhancing effort and reducing budgetary slack. This can be realized by having a budget which is not pernicious to the organization. If the prepared budget is quixotic it may affect adversely the trust and motivation level leading to dysfunctional behaviour among the employees. Gago-Rodrguez & Naranjo-Gil (2016) has proven how important trust and distrust are as informal control systems in organizations to support the extrinsic motivation for enhancing effort and reducing budgetary slack.

Trust and distrust in upper-level managers have different influences on the budgetary proposal. Based on a laboratory experiment with 160 business managers, it was found that the more middle managers trusted their upper-level managers, the more effort they committed to budgetary proposals (Gago-Rodrguez & Naranjo-Gil, 2016). Trust is very important as an informal control system in organizations, which not every stage or operation of the company's upper-level manager knows and only the manager or staff from that operation know better their expenses. However, upper-level managers still need to have doubtful feelings, and this feeling will lead the middle manager to put more effort into the budget proposal, making the budget more accurate, and reducing the budgetary slack.

Although prior studies have found that individual moral development is an important ethical element affecting decision-makers, it is unknown whether the effect of accountability-oriented control aspects of the external investigation and self-report on budgetary slack would persist in subordinates' decision-making processes when subordinates have different levels of moral development (Deng et al., 2020).

The participation of the budget is ensured by involving the entire party, from management up to the functional manager, so as not to create an information monopoly. As budget participation leads to positive communication due to an information exchange mechanism, the exchange of information and decision-making together, thus it will reduce the bias of existing budget information, thereby reducing the likelihood of budgetary slack (Wafiroh et al., 2020).

Dual Role of Budgeting

A classical agency theory serves as the starting point, with the dual role of budgeting as a planning and motivational instrument (Liessem, 2015). Based on the theory of fully reasonable utility maximizers, people should integrate the maximum amount of budgetary slack possible given budget-related compensation. As we know, when a company achieved its yearly budgeted profit, its staff will get a reward or bonus based on what they have achieved, and because of this reward, normally the manager will keep the yearly profit budget as low as he can. This is because when the yearly profit budget is lower, they can easily achieve it and get excellent ratings when it comes to performance evaluation. As a result, budgeting can be thought of as both a planning method and a motivational tool.

Participation in the budget is one of the things that has been studied a lot and is thought to have a big effect on the development of budgetary slack. When subordinates are allowed to prepare their budgets, there will be a tendency to use the information they have to prepare budgets with greater leeway. Especially when the budget is used as a tool for performance appraisal, subordinates will try to arrange a budget that is easy for them to achieve to maximize the bonuses or rewards they will receive (Ginanti & Widanaputra, 2022).

Budgetary slack will benefit the lower-level managers, but harm their upper managers because they deliberately do less than they are capable of. They will propose lower budget targets than the actual target they can achieve to their upper managers. This can occur because of an information asymmetry, which is the difference in the information obtained by agents (middle managers) and principals (upper managers). From an accounting perspective, budgetary slack has dangerous consequences for future profits or upcoming costs, harming the upper managers' resources because of the transfer to the middle managers, and losing the upper managers' trust in the middle managers because of actions taken by the middle managers (Islami & Nahartyo, 2019).

Damaging the Accountability

Budgetary slack happens when the manager who prepares the budget proposal does not have an accountability attitude. Thus far, a tendency toward budget slack creates genuine concern among stakeholders who play a part in and are affected by the budget. The budget slack possibly exerts bias in the budgeting process which is damaging to the accountability of local authorities (Mat et al., 2022). To avoid this budgetary slack based on the accountability attitude, the company or manager from other departments needs to participate and give relevant information when doing a budget proposal. This implies, among others, that while participation in the budgeting process can enhance budget performance, the effect is also contingent on the adequacy of resources the participants are presented with (Mat et al., 2022).

Employees hold themselves accountable for the budgetary task and responsibilities. They tend to justify their actions while meeting the expectation of organizations. They perceive that they have the responsibility to achieve organizational, including budgetary targets when performing budgeting estimates. Moreover, budgetary slack can also affect the behavior of managers and employees where they may be less motivated to control costs or find ways to save money. This can lead to a lack of accountability and a culture of complacency in the

organization. As a result, it could affect the performance of the organization. Van Der (2000) found that there is a negative relationship between budgetary slack and managerial short-term orientation and this is considered the spillover effect. Organizational goals and performance can be affected by budgetary slack (Yee and Khin, 2014). However, the results do not support the hypotheses that foresee that the use of budgetary goals for performance assessment and variable remuneration purposes is positively related to the creation of slack.

Theoretical Framework

A theoretical framework of budgetary slack and its detrimental effects on organizations could draw upon existing theories and concepts that provide a foundation for understanding the phenomenon. Here is a potential theoretical framework. Firstly, it can be proposed based on the consequences of budgetary slack. This includes the potentially detrimental effects of budgetary slack on organizations, which can include inefficient resource allocation, reduced motivation and effort among employees, distorted performance measurement and evaluation, compromised decision-making, and ultimately, lower organizational performance and financial outcomes. Secondly, is based on the variables of moderating factors. These are factors that can influence the relationship between budgetary slack and its detrimental effects on organizations. For example, the level of external monitoring, the effectiveness of performance measurement systems, the strength of corporate governance mechanisms, job security and the presence of ethical leadership can all moderate the impact of budgetary slack on organizational performance.

Information asymmetry can be exploited by managers to create budgetary slack, as they have more knowledge about the actual resource requirements and operational realities of the organization (Anggraini et al., 2023). In addition, Tyas et al (2022) shows that budget participation, information asymmetry, and job insecurity have a positive effect on budgetary slack. It shows that the high budget participation of public sector employees can trigger budgetary slack and information asymmetry motivates budget implementers to take action to reduce revenue targets and increase government spending the high budget participation of public sector employees can trigger budgetary slack.

Moreover, in principal-agent theory, budgetary slack can be seen as a tactic used by agents to protect their interests, such as job security, performance bonuses, or departmental autonomy, by creating slack in the budget to provide a cushion for potential shortfalls or uncertainties (Baiman et al., 2000). Tyas et al (2022) also supported the earlier findings demonstrating that a high job insecurity in the work environment creates pressure on employees and as a result the budgetary slack is created.

Based on the theoretical framework, specific research hypotheses can be formulated to test the relationships between budgetary slack, organizational performance, organizational culture, goal setting, information processing, agency costs, consequences of budgetary slack, and moderating factors in the Malaysian context. This can guide further research on the topic of budgetary slack and its detrimental effects on organizations, providing a basis for investigating the underlying mechanisms and relationships involved and offering recommendations for organizations to manage budgetary slack in a way that promotes accountability, transparency, innovation, and overall performance. Additionally, it can serve as a reference to establish the maximum amount of slack to be incorporated in the budgeting process to guarantee that there will be no negative consequences on organizations as a result of excessive budgetary slack.

The previous findings of high job insecurity in the work environment creates pressure on employees so, the budgetary slack is created could also can guide for a further research on the relationship between the job security in organizations and the degree of budgetary slack in Malaysian government agencies as well as in the private companies.

Conclusion

As argued by (Azar et. al., 2016) when the level of activity increases, more budget is allocated to it. Other than that, budgetary slack is detrimental to the organization if the budget is used as a tool for performance appraisal, subordinates will try to arrange a budget that is easy for them to achieve to maximize the bonuses or rewards they will receive (Ginanti & Widanaputra, 2022). Therefore, budgetary slack may initially seem like a helpful tool for managing uncertainty and meeting budget targets in organizations. However, many studies such as Islami & Nahartyo (2019); Mat et al (2022) suggest that it can ultimately be detrimental to an organization's financial health, transparency, innovation, employee morale, motivation and overall performance. Rohma and Chamalinda (2023) also state that budgetary slack could adversely affect non-financial variables such as product quality and going concerned.

Therefore, it is crucial for organizations to carefully evaluate their budgeting processes and ensure that they are promoting accountability, transparency, and innovation, rather than encouraging budgetary slack. Organizations need to be mindful of the potential negative consequences of excessive budgetary slack and strive to strike a balance between managing uncertainty and maintaining organizational performance. Further research can investigate the underlying mechanisms and relationships involved in the detrimental effects of budgetary slack and offer recommendations for organizations to manage it effectively. By doing so, organizations can determine the appropriate amount of slack into the budget during the budgeting process. Thus, it could lead to a more transparent, innovative, and accountable budgeting process that contributes to organization's long-term success. Another possible topic for research in the future is how organizations might reduce or eliminate the risk of having budgetary slack by factoring in the company's strategy, the nature of their operational costs, and the environment in which they do their operations.

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