

Organisational Slack, Corporate Reputation and Financial Performance

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Abstract

This discussion paper aims to fill the gap left by the latest research on organisational slack that has been focused on emerging economies or on a single company or on a single industry. Senior executives' perceptions that contribute to a measure of corporate reputation are tested as a proxy measure of unabsorbed slack. Disaggregating the components that make up reputation enables the perceptions of a company's 'ability to innovate' and how efficiently they 'use their corporate assets' to also be tested as measures of unabsorbed, perceptual or discretionary slack. The impact of these variables is considered in terms of company performance.

Keywords: Organisational slack, corporate reputation, performance management, perceptual slack, discretionary slack, Britain's Most Admired Companies survey

Organisational Slack, Corporate Reputation and Firm Financial Performance

Introduction

The strategic implications brought about by external exogenous factors impacting on organisations have reignited the debate between the traditional and the resource based view of strategy. It has also reignited discussion and debate regarding the importance of organisational slack. Put simply organisational slack is resources, usually financial, that are put aside in the event of an unexpected issue or an opportunity that an organisation might be faced with in the future. On the one hand the traditional view of strategy argues that an organisation must take note of these exogenous factors whether political, economic, cultural, demographic or technological and adjust their strategy to facilitate these factors. This philosophy suggests that the more turbulent the external environment the greater the need for organisational slack, to help level the playing field so to speak. On the other hand, the resource based view of strategy suggests that organisations with specific unique resource capabilities should seize the opportunity and build a strategy based around this capability. Here organisational slack might be seen more as a proactive source there to help the organisation seize the moment in its strategic aspirations.

The two contrasting approaches to strategy are not entirely mutually exclusive. Whichever philosophy is chosen, the relationship between organisational slack and corporate financial performance merits examination and exploration. Another area that has become increasingly significant is the relationship between intangible assets held by corporations and corporate market value. According to Hall (1992) and Bergh *et al* (2010) a corporation's reputation is a significant intangible asset that drives corporate financial performance.

Organisational Slack

Organisational theorists posit that slack helps the firm to ensure its long term survival and despite its costs has a positive impact on the firm's performance. Bourgeois (1981: 30) defines slack as:

A cushion of actual or potential resources which allow an organisation to adapt successfully to internal pressure for adjustment or to external pressures for change in policy, as well as to initiate changes in strategy with respect to the external environment.

Theory suggests that organisational slack is utilized within organisations in four primary ways. The first is that it serves as a buffer which insulates the organisation from unexpected changes in the environment (Tan & Peng 2003 and Bourgeois 1981). The second is that it is used to encourage loyalty from employees to the company by making 'payments to members of the coalition in excess of what is required to maintain the organisation' (Cyert and March 1963: 36). The third is that it is used as a resource for conflict resolution in that by using enough resources any conflict may be resolved (Tan & Peng 2003). Finally organisational slack is utilized to facilitate strategic behaviour by enabling new markets and products to be developed, providing resources for innovation and allowing alternatives to be explored in depth (Bourgeois 1981).

Similar definitions and functions of organisational slack have been developed by other academics. For example, Bowen (2002) divides slack into six functions: as an inducement; to resolve conflict; as a workflow buffer; to encourage new products and innovation; as a form of satisficing; and finally as a way of encouraging specific political behaviour. Donada & Dostaler (2005) referred to three roles of slack: avoiding discontinuity in company activities, to commence change and to adapt to external change.

A positive link between organisational slack and firm financial performance was suggested by Cyert & March (1963) and Singh (1986). However, Bromiley (1991) and more recently Sisodiya *et al* (2010) suggest that financial performance would be more like a U-shape when compared against organisational slack with organisations experiencing financial performance gains at low levels of slack, diminished performance at moderate levels of slack, and improving performance once again at higher levels of slack. On the other hand, Bourgeois (1981) and Tan & Peng (2003) suggest an inverse U-shaped performance against corporate slack, with increasing levels of corporate performance as levels of slack increase, before performance diminishing when holding too much slack breeds inefficiencies.

In contrast to organisational theory agency theory disputes that organisational slack exists at all and if it did it certainly would not result in enhanced performance. It regards organisational slack as a costly waste of valuable resources and its inefficiency inhibits the organisation's performance. Jensen & Meckling (1976: 311) state:

The firm is not an individual. It is a legal fiction which serves as a focus for a complex process in which the conflicting objectives of individuals are brought into equilibrium within a framework of contractual relations.

Agency theory suggests that managers in organisations tend to pursue own goals at the expense of the organisation such as: shirking, excessive salaries, bonuses and 'perks', empire building, excessive diversification and job security. They also have a propensity to build slack into processes on which their personal performance is assessed, such as budgets, in order to ensure that targets are achieved.

Accordingly, to the agency theorist, organisational slack is considered as a wasteful and an inefficient utilisation of an organisation's resources. Therefore organisations with high degrees of slack are not considered as potentially superior performance achievers but as wasteful organisations likely to product inferior performance.

The different types of organisational slack.

Two main types of slack exist. The first is absorbed slack, this refers to those resources that are set within the firm's procedures and are difficult to be redeployed elsewhere (Liu & Ding 2010: 3). The second type is unabsorbed slack, this is resources that are deliberately uncommitted and can be redistributed easily elsewhere within the organisation. Beyond this basic interpretation there is a wide range of alternative types of slack, some consistent with one another but different by name, others that are different in name and nature. Ansari & Millard (2010: 7-9) provide a summary of the various types of slack distinguish between financial slack, which is disclosed by objective measures, and perceptual slack which is subjective and revealed by perceptions. The latter is not dissimilar to what others refer to as discretionary slack. Bourgeois & Singh (1980) distinguished between three dimension of

slack; available slack, recoverable slack and potential slack, while Mishina *et al* (2004) refer to human resource slack and Voss *et al* (2008) customer relational slack.

This inconsistency in terms of the types of slack has resulted in empirical research attaining differing findings. Some forms of organisational slack may lead to superior performance while another type will not. Liu & Ding (2010) argue that the relative impact of organisational slack on product innovation is actually determined by the type of slack identified. Tan & Peng (2003) considered the relationship between performance and absorbed slack (where resources are committed to the firm's existing processes) and between performance and unabsorbed slack (where resources are not committed), they found that 'organization theory generates stronger predictions when dealing with unabsorbed slack, and... agency theory yields stronger validity when focusing on absorbed slack. [They also found that]... the impact of slack is curvilinear, which resembles inverse U-shaped curves.' (2003: 1249).

Impact of Organisational Slack on Corporate Performance

Early in the debate on organisational slack, Bourgeois (1981) suggested that the impact of slack needed to move from a topic of theoretical debate and discussion to one where the debate and discussion is developed through empirical research. The paper suggested that organisational slack could be measured using various financial ratios taken in combination. Subsequent empirical research seemed to suggest a positive relationship between organisational slack and corporate financial performance, although this was not conclusive (see for example, Singh 1986, Hambrick & D'Aveni 1988, Bromiley 1991 and Miller & Leiblein 1996).

Other empirical studies suggest that the relationship is not clear cut and nor are all measures of organisational slack related to positive financial performance (Greenley & Oktemgil 1998). Greenley & Oktemgil found that the positive relationship between organisational slack and performance existed in high performing firms but such an association was not present in low performing firms.

Much of the earlier empirical work on the impact of organisational slack on firm performance used financial ratios as proxies to measure organisational slack. Simsek *et al* (2007) and Ansari & Millard (2010) noted that research conducted only using financial ratios may result in a circulatory problem where it is not possible to determine whether organisational slack was due to a conscious decision to have that slack. It is also possible that since level of organisational slack is measured using financial data, as is corporate performance, there is a possibility that the same data is used to assess both the independent and the dependant variables.

Greenley & Oktemgil (1998) suggested that using only financial data to measure slack was limiting and measuring slack should be augmented by incorporating subjective measures based on managers' perceptions and that these should be compared with the financial ratio based measures. This approach was adopted by Ansari & Millard (2010) in their empirical study. They used financial ratios as proxies to measure available slack (uncommitted slack), recoverable slack (committed slack but can be recovered with some effort) and potential slack (slack that can be recovered from external sources if needed). They then 'used a four-item measure developed by Simsek *et al* (2007)' (2010: 18) to measure perceptions of

discretionary slack, recognising that discretionary slack was closely related to unabsorbed or available slack. These slack measures were then compared with financial performance to assess whether or not any relationship existed. They found that only the discretionary slack related to managerial perceptions has a positive impact on performance and they concluded that 'to search and pursue growth organisations need to manage discretionary slack as they creatively find and deploy the right resources for devising and implementing growth strategies' (2010: 28).

Proposed Future Empirical Study

In the main, the limitations of recent empirical studies and suggested areas for future research identified in three academic papers (Ansari and Millard, 2010; Bergh, 2010 and Tan and Peng 2010) are driving our development for future research in areas of perceptual slack and corporate performance, and these form the basis of this discussion paper.

First, references to empirical work on perceptual slack are limited to single corporate entities or industrial sectors. Ansari & Millard (2010) noted that the small studies make it difficult to generalize across different companies and industrial sectors. To address this limitation it is proposed that measures of corporate reputation be used as proxies for perceptual slack. Britain's Most Admired Companies (BMAC) survey into corporate reputation is a peer-perception survey incorporating perceptions by senior executives of leading UK companies. Data is available on ten companies in each of 23 industrial sectors in the UK since 1994. Given the large data set resulting from the BMAC surveys and the exclusive access to the separate component parts, it may be possible to offer overarching conclusions on the impact of perceptual slack on corporate performance.

Second, Bergh *et al* (2010) explored the network development of resources, through the resource based view, and the resultant impact on firm performance. Their focus was on knowledge based and human resources, but they suggested that further research could be conducted on using corporate slack to develop intangible resources using corporate reputation resources. The resultant intangible resource development could then be assessed against the impact on financial performance. The BMAC surveys' aggregate scores contribute towards a reputational score for companies. This data could be used to examine the relationship between reputation, organisational slack and corporate performance.

Finally, Tan and Peng (2003) made comparisons between the significant retention of slack resources in Chinese companies and the retention of slack resources in western countries. They suggested that one reason for the high incidence of the retention of significant slack by Chinese companies was because of the underdeveloped Chinese financial markets. Where developed financial markets exist, the propensity to hold higher levels of slack is neither desirable nor possible. Developed financial markets would make it possible to acquire potential slack resources easily when needed. Developed financial markets would also prevent companies from holding excessive slack by discounting their market value if this were the case. However, the recent worldwide financial crisis has made it difficult and expensive to obtain financial resources needed to develop future slack resources. It would be interesting to study whether there was an increasing propensity to hold more of slack during this period compared to the period before the financial crisis.

Britain's Most Admired Companies

Britain's Most Admired Companies (BMAC) survey attempts to provide a measure of the corporate reputation of companies. It is composed of nine criteria which when summed together contribute towards a company's reputational score, these nine are: the quality of management, the company's financial soundness, the quality of its products, its ability to attract the best people, its value as a long term investment, its capacity to innovate, the quality of its marketing, its community and environmental responsibility and finally how effectively it utilises its corporate assets.

Examples of the questions we begin to consider are:

- What is the relationship between company reputation, organisational slack (absorbed and unabsorbed (perceptual) and company performance?
- Are companies with a higher or lower reputation, incorporating higher or lower levels of slack within their organisation, associated with superior or inferior performance?

Disaggregating reputation into its nine constituent parts provides an opportunity to exclusively extract executive perception for two key constituents in the development of our research. This is firstly the perception of a company's 'capacity to innovate' and secondly how efficiently a company utilises its 'use of corporate assets'. Further provocative questions of interest arise:

- What is the relationship between perceptions of companies' capacity to innovate, organisational slack (absorbed and unabsorbed) and company performance?
- What is the relationship between companies that possess higher esteem in terms of how efficiently they operate their corporate assets with higher or lower levels of organisational slack Absorbed and unabsorbed and the subsequent impact on performance?

Drawing on the work of Ansari and Millard (2010) we distinguished between; absorbed slack (often indicated by objective, financial measures) and unabsorbed slack (considered here as perceptual slack) where the measures are subjective. The BMAC information providing subjective measures of senior executives' perceptions would be a proxy for perceptual slack.

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