CAHRS ResearchLink
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Give Them Some Slack - They're Trying to Change! The Benefits of Excess Cash, Excess Employees, and Increased Human Capital in the Context of Strategic Change

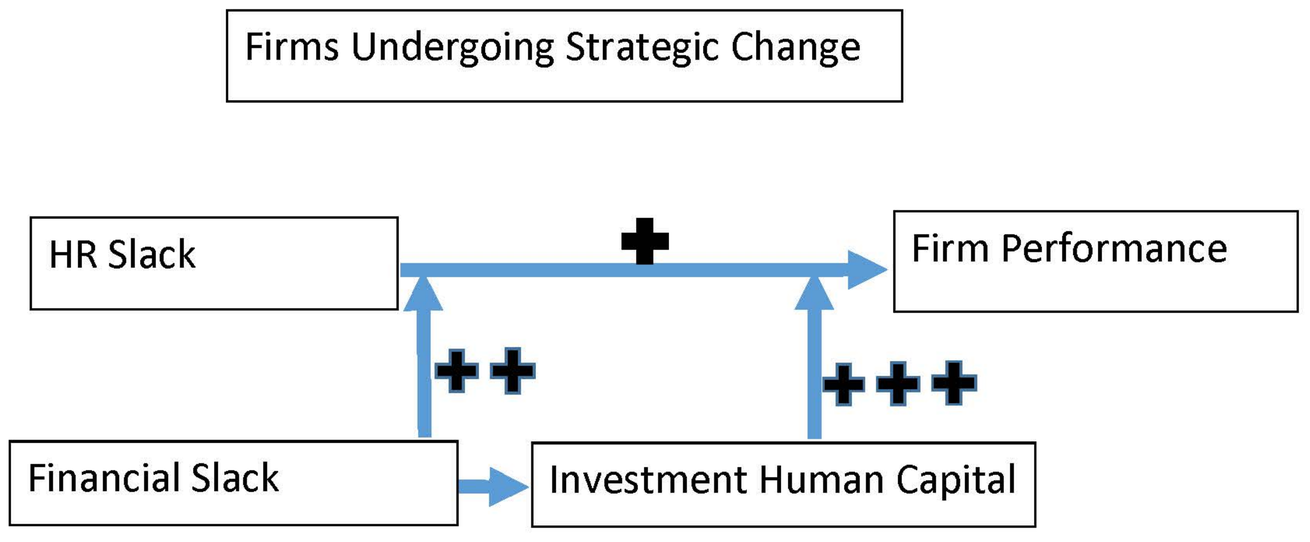
The Challenge and the Study

Human resource strategists perennially struggle with the issue of staffing levels, especially the difficult task of determining the number of people required to meet their units' business goals. Should they go "lean and mean", as the saying goes, or is it better to overstaff a bit – to build a little slack in the system? Theory suggests that the answer to this question is "it depends". Units experiencing periods of stability with little change are advised to opt for the former approach in the interest of enhancing operational efficiency and minimizing labor costs. Those undergoing strategic change, however, would do better to build in some HR slack to allow for the allocation of talent to the exploration and early staffing of new initiatives without detracting from current operations. This notion of contingency has some empirical support with respect to financial slack, but to date there is no comparable research on HR slack.

The study reported here fills this gap, while taking the additional step of exploring whether HR slack and financial slack have complementary effects on firm performance (see Figure 1 on page 2). Initially, the study examined whether the role of HR slack differed in firms that were and were not undergoing strategic change. Second, the analysis focused specifically on firms undergoing strategic transitions and explored two questions: (1) To what extent did the existence of financial slack affect the relationship between HR slack and firm performance? And (2) to what extent did it matter whether or not firms chose to allocate a significant portion of their financial slack to developing their human capital? To help answer these questions, the study relied on data provided by the Federal Deposit Insurance Company (FDIC) pertaining to 6,606 commercial banks covering a 12-year period between 2002 and 2014.

As shown in Figure 1 below, the overriding context of the study was the presence of strategic change; banks were considered to have engaged in strategic change if their principal product shifted from consumer loans to commercial loans – or vice versa – over a two-year period, and to have been stable otherwise. HR slack existed in banks with a higher than average ratio of employees to sales, while financial slack obtained in those with a higher than average ratio of current assets to current liabilities. Changes in human capital investment captured year-to-year differences in the ratio between the financial resources firms spent on training, salaries, and bonuses and the total number of employees they had at the time. The measure of firm performance was Tobin's *q.* This measure depicts the difference between a firm's market value and the replacement cost of its assets and, thus, is a good indicator of the premium the market is willing to pay for value added via effective resource management.

Figure 1



The Major Results

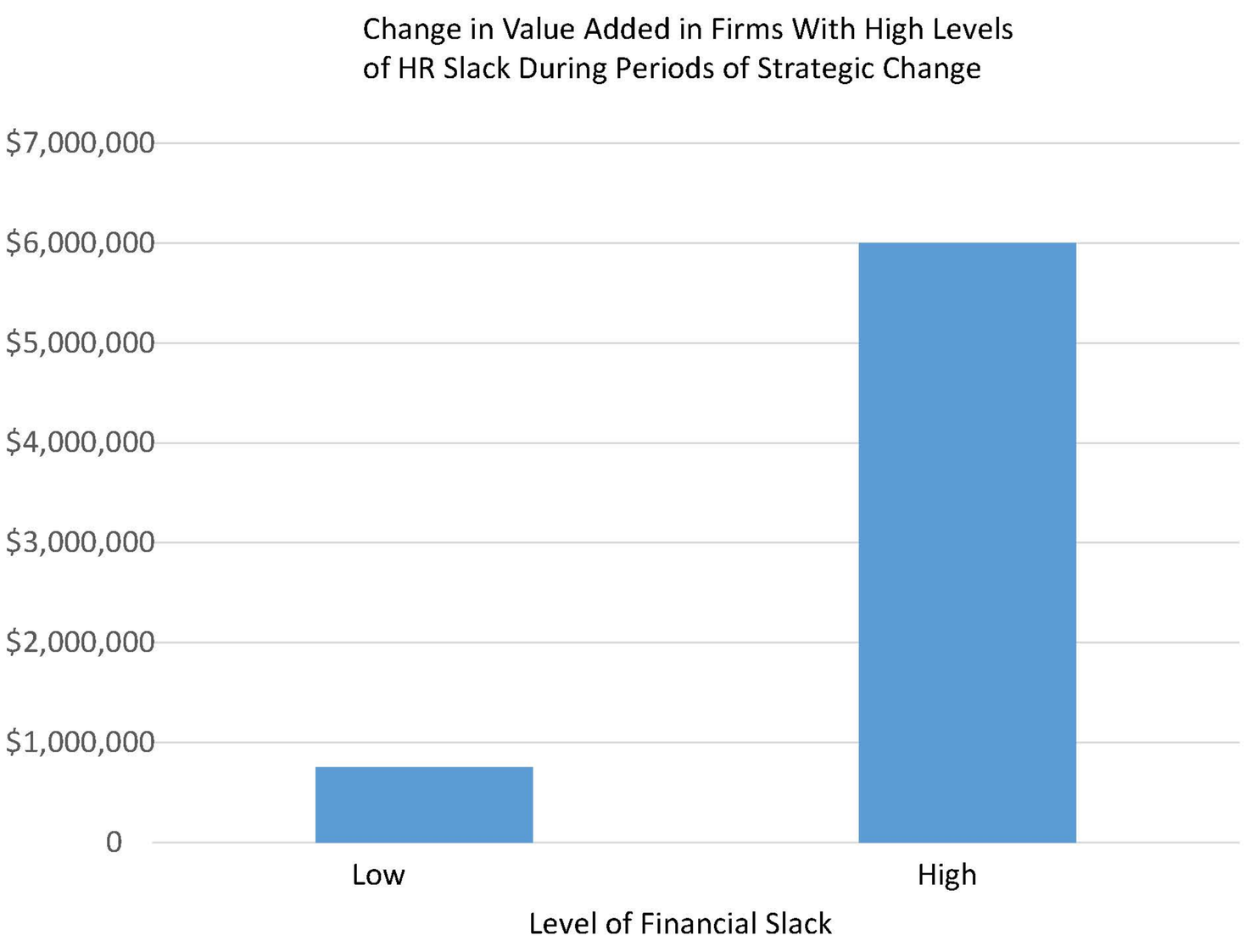
After controlling for the effects of numerous factors that might affect firm performance (e.g., firm size, prior levels of performance, changes in physical capital investment, and location):

- As expected, HR slack had a statistically significant negative effect on firm performance in banks not undergoing strategic change and the exact opposite effect on firm performance in banks where these transitions did occur.

- Among firms engaged in strategic transitions, level of financial slack affected the positive relationship between HR slack and firm performance. At a low level of financial slack, the relationship remained significant and positive, but as the level of financial slack increased, this relationship grew progressively stronger. In firms with a level of HR slack just one standard deviation above average but with only modest levels of financial slack, Tobin's *q* increased by about $750,000. In firms with comparable levels of HR slack but larger financial buffers, the increase in Tobin's *q* was over six times greater - approximately $6,000,000 (see Figure 2 below).

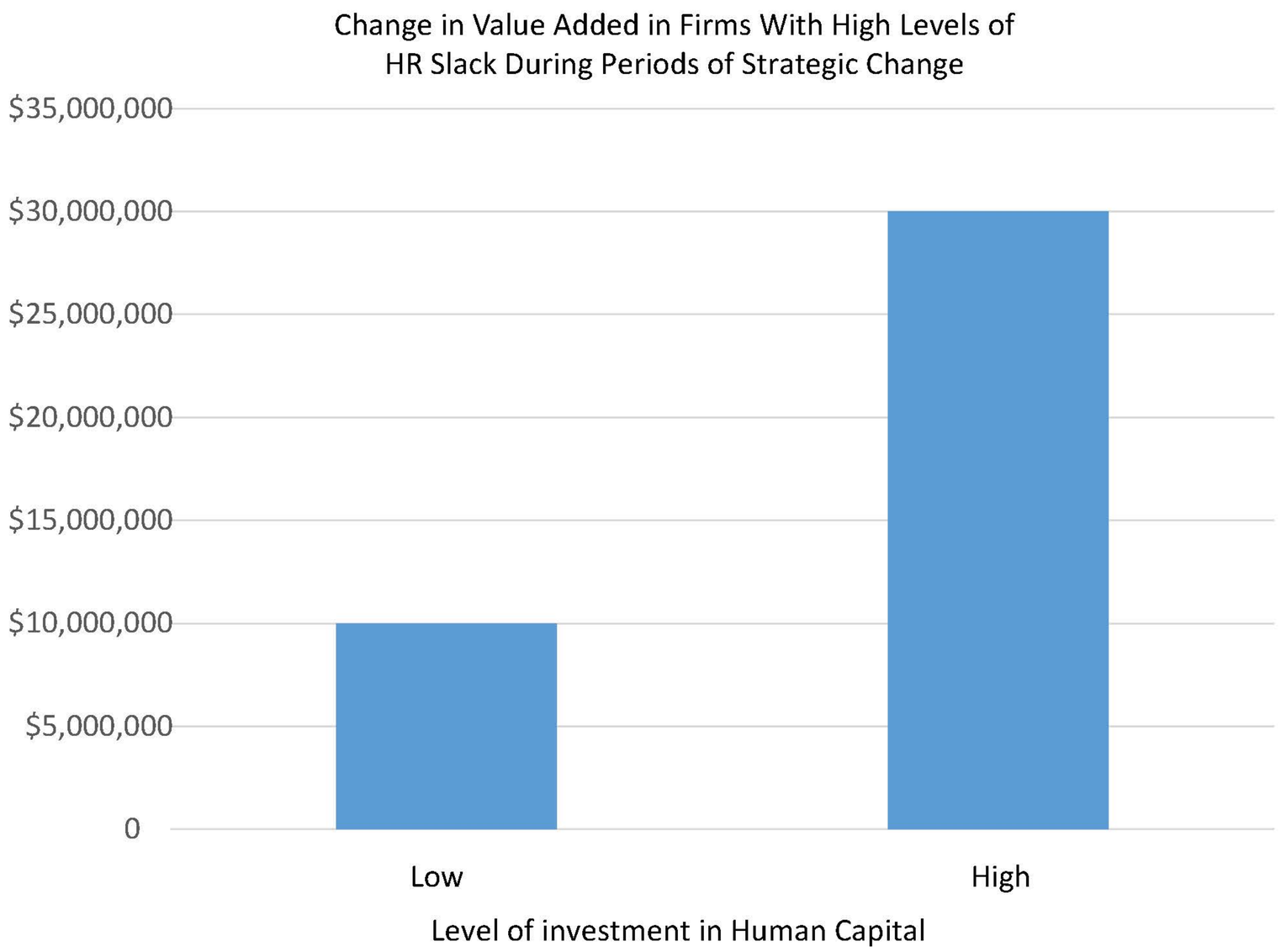
- Firms undergoing strategic change were significantly more likely to use their financial slack to enhance their investments in human capital than were their stable counterparts.

Figure 2



- These investments in human capital made a big difference. Even when they went up only modestly, the relationship between HR slack and firm performance was positive. When they went up substantially, however, the relationship was considerably stronger. Again, with HR slack levels just one standard deviation above average but low levels of investments in human capital, Tobin's *q* increased by about $10,000,000. With comparable levels of HR slack but major investments in human capital, Tobin's *q* shot up to $30,000,000 (see Figure 3 below). Although data limitations precluded an all-out cost-benefit analysis, a supplemental examination of the data using net income rather than Tobin's *q* as the measure of firm performance produced similar results, suggesting that the increased investments in human capital paid off handsomely in terms of operating as well as market results.

Figure 3



Implications For Practice

The results of this study have important implications for HR strategists.

First, as theory suggests, organizations are wise to avoid the buildup of HR slack during periods of stability when no strategic change is imminent. In such times, HR slack encourages the lax use of resources that inevitably weighs on productivity, incurs unnecessary labor costs, and – as this study shows – ultimately results in lower levels of firm performance.

As theory also suggests, though, the judicious accumulation of HR slack in anticipation of strategic transitions is a wise course of action. It provides much-needed flexibility that facilitates the initial staffing-up of new initiatives without having to cannibalize ongoing operations. Among the banks studied here, the a priori accrual of HR slack in and of itself led to significant increases in firm performance.

But this is not the whole story. Even before they begin to assemble HR slack, HR strategists would be wise to enlist the support of their friends in finance to commence the accumulation of financial slack as well. In this study, for example, the coexistence of relatively high levels of both HR slack and financial slack led to financial results that were six times higher than the results attained when HR slack was ample, but financial slack was lacking. The reasons for this are unclear, although it may reflect the measure of financial results used in the study; the market may have anticipated that the well-endowed banks would make productive use of their excess funds.

If so, this was a good call – assuming investors had in mind using a substantial portion of the accumulated financial slack to invest in the firms' human capital. That is, if they expected HR strategists to use some of the money to provide training to enhance the knowledge and skills of not only the newly added employees, but also those who would at some point shift from existing operations to the new ventures. And then to put much of the remaining funds into providing incentives for employees to motivate them in part to accept rather than resist the anticipated changes and in part to put forth the extra effort needed to bring the new initiatives to fruition. In the extant study, banks that had levels of HR slack just one standard deviation above the average, while also investing heavily in their human capital increased their market value by about $30,000,000. Similarly situated firms that failed to accumulate financial slack in a timely manner or accumulated it but failed to invest in their human capital experienced market returns that were $20,000,000 lower -- seemingly a case of being penny wise and pound-foolish.



Conclusion

HR slack is a curse and a blessing. A curse for firms operating in stable environments with no immediate plans to shift strategies. And a blessing for those anticipating or entering the early stages of a strategic transition. To get maximum bang for the buck, though, savvy HR strategists in change-oriented environments must assure that their build-up of HR slack is preceded by a simultaneous accumulation of financial slack and, further, that these funds are wisely invested in developing the abilities and motivation of employees who can make or break the new ventures.

Or so this study suggests. But all studies have limitations that caution against over-interpretation, and this one is no exception. For example, the study took place in banks, service organizations whose performance is heavily dependent on their employees; perhaps the roles of human, financial or even physical capital would be different or produce different results in other settings. This study focused on ultimate outcomes (Tobin's *q* and net income); future studies might consider including more operational outcomes such as labor productivity and/or service or product quality. And it would be helpful if some of this research could involve intensive case studies that followed decisions to undertake strategic change from beginning to end to allow in-depth analyses not only of the processes leading up to strategic change, but also of the unfolding events during the change and the outcomes that follow. At what point in strategic transitions, for instance, does it make sense to begin to eliminate HR slack, financial slack or even change-specific investments in human capital?

CAHRS companies may find themselves in situations where it would be helpful to understand how to do a better job of managing HR and financial resources during strategic transitions. As always, when these situations arise, we urge the HR strategists involved to partner with CAHRS researchers who not only have the expertise to do these types of studies, but also the capacity to carry them out efficiently and effectively.

Researcher



Rebecca Kehoe, Associate Professor of Human Resource Studies at the ILR School, Cornell University.

This ResearchLink is based on an article published in the *Academy of Management Journal* (https://doi.org/10.5465/amj.2018.0272) co-authored by F. Scott Bentley and Rebecca Kehoe. The research was conducted while both authors were at Rutgers University. As noted elsewhere in this Link, Professor Kehoe will be joining the ILR School faculty this coming summer.