To the Graduate Council:

I am submitting herewith a dissertation written by Judith R. Hunt entitled "Strategic Compensation: An Exploratory Study of the Relationship of Strategic Management and Executive Compensation Systems in Three Separate and Independent Firms." I have examined the final copy of this dissertation for form and content and recommend that it be accepted in partial fulfillment of the requirements for the degree of Doctor of Philosophy, with a major in Business Administration.

Max S. Wortman, Jr., Major Professor

We have read this dissertation
and recommend its acceptance:

Accepted for the Council:

Vice Provost
and Dean of The Graduate School

STRATEGIC COMPENSATION:
AN EXPLORATORY STUDY OF THE RELATIONSHIP OF STRATEGIC MANAGEMENT AND EXECUTIVE COMPENSATION SYSTEMS IN THREE SEPARATE AND INDEPENDENT FIRMS

A Dissertation

Presented for the

Doctor of Philosophy

Degree

The University of Tennessee, Knoxville

by

Judith R. Hunt

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DEDICATION

This dissertation is dedicated to the memory of my mother, Emma Morris Hunt -- a consummate teacher and wonderful friend.

ACKNOWLEDGMENTS

During the course of the Doctoral Program and the writing of this dissertation, each of my Committee members contributed to my education in a unique and different way. I am deeply indebted to Professors Max S. Wortman, Jr., H. Dudley Dewhirst, Kyle Reed and Roger Bowlby for the expertise, time, and encouragement they have given to me. Without them, I would not have had the fortitude to complete this project.

ABSTRACT

Strategic compensation, the process of deliberately designing an executive compensation system to facilitate the achievement of both short-term and long-term goals, was the focus of this research. The research was conducted from September 1983 to November 1986. The purpose of the research was to identify variables operating in strategic compensation systems, and to learn how the systems were designed and operationalized. A pilot study conducted in the Fall of 1982 indicated that a few firms were utilizing strategic compensation, but the number of such systems was small.

Because of the recent development of strategic compensation, an exploratory, holistic case study was designed and completed in three unrelated firms in the banking and finance industry. In each company, the system design and administration was investigated, and major variables affecting the system were examined. Following the individual case analyses, a cross-case analysis was performed with the intent of generalizing to strategic management theory if the results so warranted.

In the cross-case analysis, the external variables which were identified and monitored in the design and administration of the executive compensation plan were the industry in which the firm operated, the compensation plan

of competitors, and economic variables, particularly inflation and tax laws. The internal variables were size, culture, strategy and resulting structure, and financial constraints. Although firms attempted to forecast changes in these variables, none had a mechanism for handling major changes which occurred after executive performance objectives had been established.

While each firm had a distinct compensation system, certain similarities were observed. All firms had several points where the strategic management process and the strategic compensation system were either coincidental or had information exchanges. Executives were aware of both corporate objectives and their own performance objectives. In no firm, however, did a formal mechanism exist for handling problems in the compensation system.

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CHAPTER 1

INTRODUCTION

Management has spent the last thirty years developing and refining methods of operating businesses more efficiently and effectively. During those three decades, the evolution of planning, long-range planning, and strategic planning has culminated in the development of strategic management. While strategic management is recognized by both academicians and practitioners in the field of management as a subfield designed to enhance the achievement of organizational objectives, there has been little concurrent development in the design and administration of compensation systems to reinforce the success of the overall strategic management process in any given firm. The issue which was addressed in this study centers around the incongruence of the utilization of strategic management with its concern for the future and the concurrent emphasis on the short-term results for which managers are rewarded. There is an inherent contradiction in a commitment to the long-term and a reward for the short-term.

While very few companies have attempted to address the issue of strategic compensation, many companies have at least recognized its existence. This study examined three firms currently utilizing, and trying to refine,

their compensation systems with the express purpose of enhancing the achievement of both long-term and short-term goals.

This chapter briefly discusses the following topics: strategic compensation systems, the purposes of the study, and the significance of the study to the field of strategic management, academicians, and practitioners.

Strategic Compensation Systems

The number of firms currently using some type of strategic compensation system is in dispute. Part of the discrepancy stems from what firms consider to be strategic compensation. Authors of studies in this area have generally accepted the standard that strategic compensation is used when a firm offers any type of reward for contributions to the long-term well being of the firm (29, 42, 43, 56, 62, 65). The most common forms of long-term rewards are stock options (the right to buy stock in a company, usually at a fixed price for a period of time ([41, p. 420]), bonuses (cash payment usually based on the company's performance in a given year, paid out after the year is over [21, p. 3]), and golden parachutes (special compensation given to executives if they are negatively affected by the acquisition of their firm by another [41, p. 423]). Estimates of the percentage of firms using

long-term incentives range from 10 to 80 percent (29, 42, 43, 56, 62, 65).

While the reasons that firms use long-term incentives vary, one factor is competition among firms for competent top management. First, in order to attract and retain good management, firms have to offer compensation packages that are competitive (42). Since information describing the current top management compensation plans is more readily available to executives today than in the past, there is additional pressure to make compensation packages even more competitive.

Second, some types of long-term incentives provide more flexibility to top management in determining their personal incomes in a given year. Because many executives have other income sources, it provides them with a means of lowering their personal income taxes. Many of these types of incentives have been developed in response to changes in the Internal Revenue Code (59).

Third, some feel that long-term incentives increase the probability that top executives will resist the temptation to sacrifice the future health of their organization for an increase in current profits (43, 56, 74, 75). In other words, long-term incentives counter the traditional emphasis of reliance on short-term measures of managerial performance.

Fourth, long-term incentives may provide a statement about commitment to the achievement of long-term organizational objectives. If a corporation rewards management for attaining long-term goals, then the importance of these goals is being emphasized.

Fifth, some long-term incentives can be an inducement for top management to stay with the company. Theoretically, when top management acquires longevity, there is experience with and loyalty to a firm. This combination of experience and loyalty enhances the effectiveness of decisions made by top management in the firm's behalf.

Although firms may have applied one or more of these reasons in the decision to use long-term incentives, a systems theory approach may also explain why the use of long-term incentives is theoretically sound. In other words, firms may actually use long-term incentives for any one or more of the above reasons. While practicality may be the prime consideration from the point of view of the firm, the theoretical soundness of the use of long-term incentives by the firm is not obviated by that practicality.

Long-term incentives could be a part of a total compensation system developed within the total strategic management framework of the firm with the express purpose of motivating top management to make decisions consistent

with both long-term and short-term objectives. Several authors have pointed out that it is incongruous to employ strategic planning with its long-term implications, and then overemphasize short-term results such as earnings per share and quarterly profits (26, 52, 69, 75).

The idea of a strategic compensation system is supported in theory by Ansoff, a pioneer in long-range planning concepts, who stressed the need for integration of management systems (42, p. 10). In 1957, Selznick stated the importance of institutionalizing corporate strategy because failure to do so could undermine it (42, p. 10). To be consistent with the concept that corporate strategy must be institutionalized requires that the compensation system be designed and administered to reinforce the successful implementation of strategy. While this may appear to be an obvious necessity, the number of firms actually engaged in strategic compensation planning is small. Many of these firms appear to be experimenting with the systems, indicating that the systems are not yet satisfactory.

While experimentation with the strategic compensation systems may appear to be an unsound practice, experts in the field believe that firms should try to develop a system which is tailored to the needs and circumstances of each individual firm (24, 39, 42, 53). The idea of developing a unique strategic compensation system is closely linked to

the concept of the contingency theory of strategic management. Such a system would take into account both common and unique variables for each firm, and the system should be accorded a major variable status in the strategic management process.

Other experts believe that compensation and the strategic management process are linked primarily in certain areas such as implementation (8, 50) and control (72). Regardless of whether or not strategic compensation is considered a major variable, many strategic management theorists recognize compensation as a powerful motivational tool (8, 46).

Several well-developed and well-accepted motivation theories have been proposed. The major theories are drive theory, expectancy theory, two-factor theory, and equity theory (36). While each of these theories explains motivation somewhat differently, each theory attempts to explain why people behave as they do. In the framework of strategic management, the importance of compensation lies in what it can or cannot motivate people to do.

Studies of executive and managerial compensation focus on three major topics, the first of which is whether or not companies do pay for performance. Research indicates that most companies do not pay for performance. Many other variables, such as industry, size of the firm,

and past policy are important determinants of compensation.

Whether or not companies should pay for performance is the question addressed in the second major topical area. Studies in this area are designed to test the motivational assumption that it is possible to improve executive or managerial performance through a pay for performance compensation system. While there are results which support both views, the Rich and Larson study provided a more informative conclusion; namely, that compensation systems must be clearly understood by those they affect in order for pay for performance to work (62).

The viability of strategic compensation is the final topic considered. Very few studies exist on the topic primarily due to its recent development. A study by Higgins indicated that there is a potential to reinforce the achievement of corporate goals through the use of long-term incentives established during the planning process (29). Because there are no studies done on strategic compensation, per se, preliminary research on the topic is the major purpose of this study.

Purposes of the Study

The purposes of this study are: (a) to investigate the operations of the strategic compensation system in three separate, independent firms; (b) to attempt to

identify major variables in these systems; (c) to determine if strategic compensation planning may become another component in the strategic management of firms; and (d) to provide practitioners with a potential model of a strategic compensation system which may be modified for use in their organizations.

Significance of the Study

The study has both theoretical and practical significance. In a larger, theoretical sense, this study is one of the first to investigate how reward systems can be integrated into strategic management. Over the past thirty-five years, very distinct technical skills have been developed to administer compensation programs in organizations. For decades, human resource departments have been removed from the mainstream of activities involved in production or service. Many staff members responsible for the design and administration of pay systems have been more concerned with the technical details of their programs than with providing useful tools for managers (75, p. 62). The inclusion of strategic compensation systems under the purview of strategic management may be useful in institutionalizing strategic management within an organization.

Since the study of strategic compensation is so new, many avenues of research have opened up for academics and

students of strategic management. Once variables operating in strategic compensation have been identified, their importance and influence in firms with differing structures and utilizing different strategies can be determined. Additionally, there is the possibility that firms utilizing strategic compensation may be more financially successful.

The significance of this study to practitioners falls into two main areas. The first area is concerned with maintaining corporate freedom to determine executive compensation; there is some indication that this freedom may be curtailed. The second area is concerned with proposing a model for practitioners to use to initiate strategic compensation in their firms.

Maintaining the freedom to pay executives without the threat of government intervention has become a concern for corporations. There are three main reasons why this concern is warranted.

First, an informed public has become sensitive to the extremely high salaries of top managers in large firms. Questions have been raised as to whether or not managers are worth the high salaries they receive. In major union-management negotiations, it is not uncommon for the media to make executive salaries known to the general public. Outcries from union members and members of society at large have not gone unheard by members of Congress who

sometimes respond by demanding investigations into alleged flagrant abuses of stockholders' funds.

Second, stockholders have become more demanding in wanting justification of executive salaries (45, 69). Armed with studies that show no statistically significant difference in compensation for profitable and unprofitable firms, stockholders have become more and more reluctant to approve requests for major increases in top management compensation (45).

Third, the Securities and Exchange Commission (SEC) has begun to require a fuller disclosure of executive compensation for current and potential investors. While the SEC is aware of the problems of presenting such information in a way that is distortion free, the SEC's requirement marks the beginning of government intervention in corporate pay practices. Due to a major change in the attitude of people towards very high executive salaries, the possibility of corporations witnessing severe government intervention into executive salary practices in publicly held corporations has become more likely (56).

Because attention to this topic may ward off further government, stockholder, and social critic intervention into corporate pay practices, this study holds practical significance.

This study also has proposed a model for practitioners to initiate strategic compensation in their

firms. This is the second main area of significance for practitioners. Such a model should offer a means to present a logical defense of compensation practices to those outside of the firm who have concerns as to the appropriateness of the executive compensation plan.

Summary and Conclusions

Over the past three decades, experts in the field of management developed long-range planning, strategic planning and strategic management. Ideally, in a firm utilizing strategic management, all systems operating within that firm would reinforce the achievement of both short-term and long-term corporate objectives. Ironically one important system with great potential for enhancing the achievement of corporate objectives has been largely ignored, even in companies where strategic management is practiced. Only recently have some corporations become interested in what their reward systems are motivating people to do in the long term.

Corporations have begun to take their reward systems seriously because of government and shareholder interest in executive pay. Without a systematic method for defending an executive's pay, a corporation is inviting further government and shareholder scrutinization. The longer-term implicaiton is government control, such as the formula for executive pay suggested by Drucker (12, p. 48).

In addition to the potential threat from the government, corporations must stay competitive in terms of executive compensation. To fail to do so could result in the loss of several key executives -- a chance many corporations are unwilling to take.

Strategic compensation is a new consideration in the process of strategic management. This study serves to provide an initial look at three companies in a dynamic industry, and how these companies have addressed the design and administration of an executive compensation system to accommodate the uniqueness of each firm and to enhance the achievement of corproate objectives.

This chapter has presented and discussed the issue of the study, the purposes of the study, and the significance of the study to the field of strategic management and to practitioners in the field. The next chapter will present the literature in the field.

CHAPTER 2

LITERATURE REVIEW

Strategic compensation planning, the systematic inclusion of strategy into the design and administration of executive compensation plans, is related to the field of strategic management both directly and indirectly through several major topics. These include: strategic management models which use incentives or rewards as a distinct variable in the model; the role of incentives or rewards in strategic management; motivation theories; executive compensation studies; and factors which have been shown to or are postulated to affect executive compensation systems. Following a discussion of these topics, a model shows the relationship of executive compensation to strategic management.

Strategic management is defined as:

> being concerned with the long-range goals of an organization and with the course or courses of action to achieve them, considering environmental conditions, available resources, and degrees of risk (30, p. 7).

The emphasis in strategic management is the achievement of long-term goals. Ideally, all systems operating within a firm practicing strategic management should reinforce the achievement of both short-term and long-term goals. The integration of all systems is a basic tenet which was introduced early in the development

of the field of strategic management. While the omission of some systems may cause lack of synergy, failure to include top management compensation may cause the sacrifice of long-term goals. The dollar cost in terms of present and anticipated results could be quite high. Firms are willing to spend large amounts of their resources on strategic management systems with their long-term implications, and then fail to consider what their compensation system motivates people to do.

Not all strategists have failed to consider strategic compensation. While that exact terminology may not be used by the following authors, the implication is clearly present that the rewards a firm gives, and the actions that are rewarded, are an integral part of the strategic management of the firm. In other words, it is considered to be a variable worthy of inclusion into an overall strategic management model.

Strategic Management Models Which Use Incentives or Rewards as a Variable in the Model

Lorange included management incentives as an "integral stage of the corporate planning system" (39, p. 51) (see Figure 2.1). His justification for that inclusion was based on the possibility of conflict between the achievement of corporate strategy (long-run) and top management's personal goals (short-run). There is little dispute about the existence of pressure on managers to

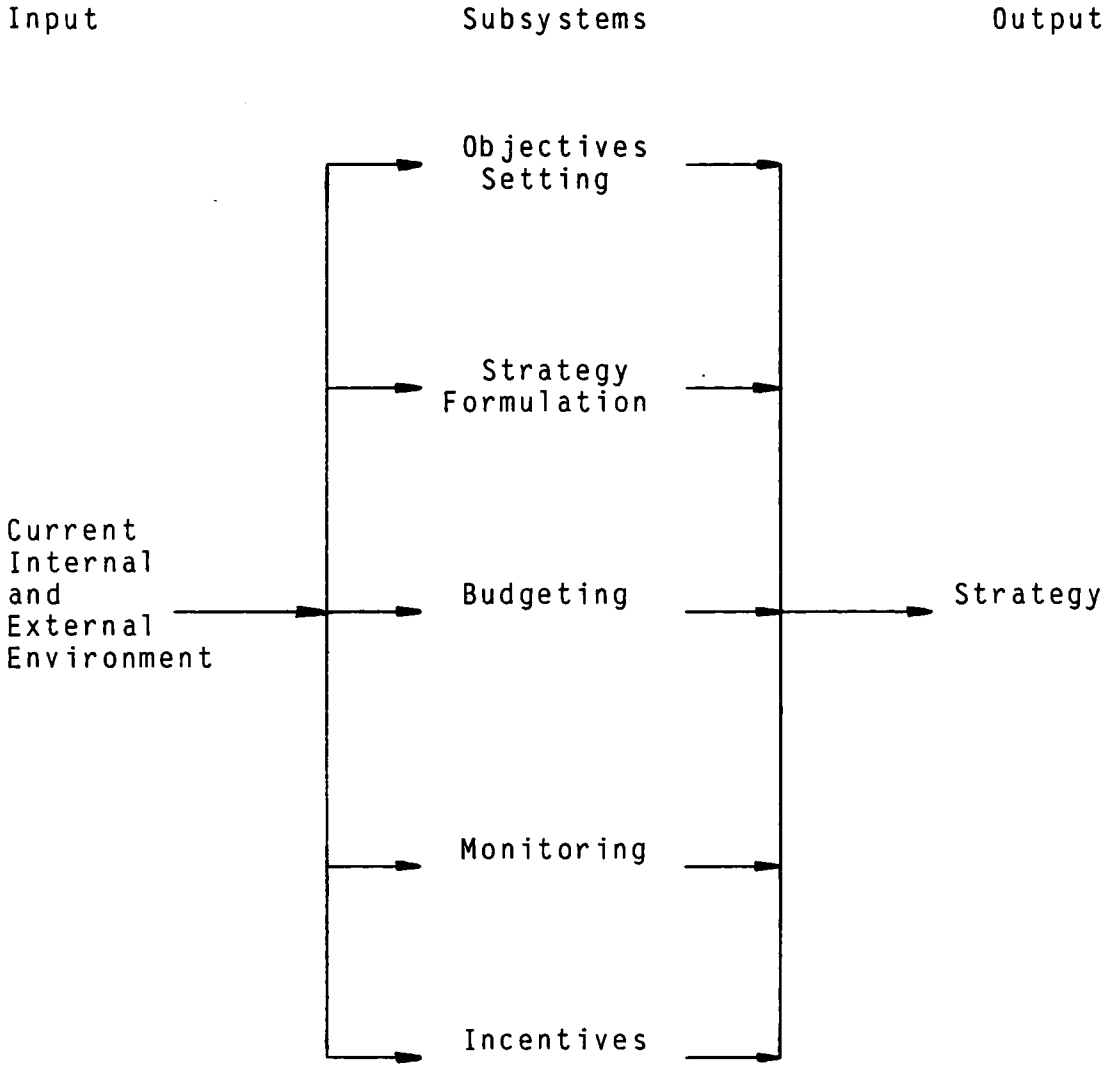


Figure 2.1. All of the Corporate Planning Subsystems Showing Incentives As a Separate Subsystem.

Source: Adapted from Peter Lorange, Corporate Planning An Executive View-point. Englewood Cliffs, New Jersey: Prentice-Hall, Inc., 1980, p. 215.

move to the fast-track and have frequent job transfers. As a consequence, long-term goals may be slighted in favor of short-term goals to acquire a good record for a promotion. While a manager is accountable for the consequences of decisions made in a current position, he/she is usually not held accountable for the consequences of decisions made in prior positions. Therefore, Lorange surmised that inclusion of the incentives system into the planning process will reduce goal incongruence between the organization and the individual (39, p. 53).

The linkages between incentives and other planning elements are shown in Figure 2.2. Linkage A, which connects incentives to objectives setting should be a strong one to stimulate managers to take the longer-term strategic direction. The importance of incentives to the budgeting process is illustrated in Linkage C. The motivation to carry out entire strategic programs, rather than ignore the long-term aspects of the program, should be facilitated by Linkage B (39, pp. 192-202). Not only did Lorange describe the variables in his model, he also described the way in which they interacted with one another.

Galbraith and Nathanson acknowledged the importance of the reward system by designating it a "major organizational design variable" (26, p. 2). In Figure 2.3, the relationship is shown between strategy, organizational

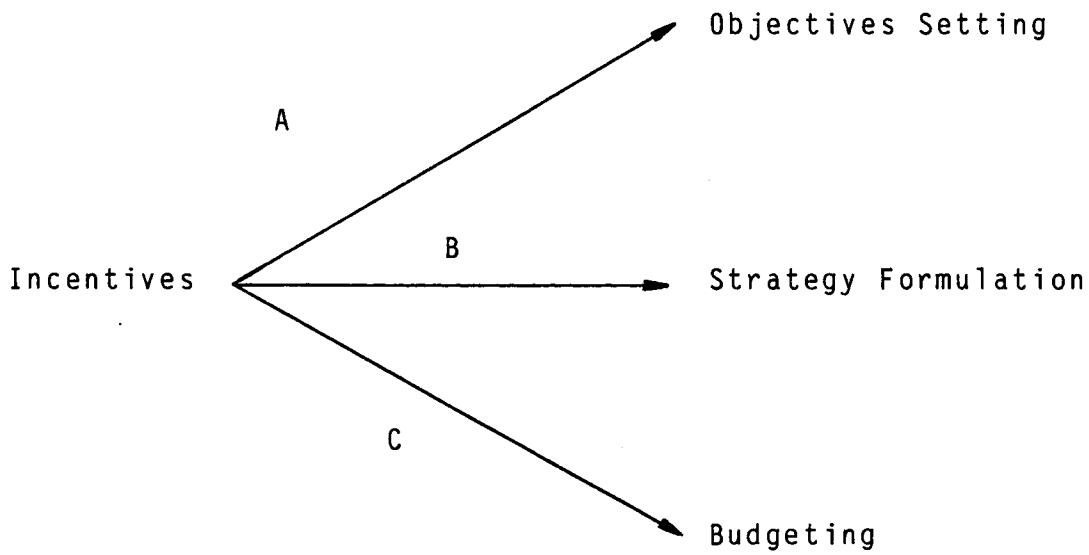


Figure 2.2 The Linkages A, B, and C Between the Management Incentives Subsystem and Other Subsystems in Corporate Planning.

Source: Adapted from Peter Lorange, Corporate Planning An Executive View-point. Englewood Cliffs, New Jersey: Prentice-Hall, Inc., 1980, p. 215.

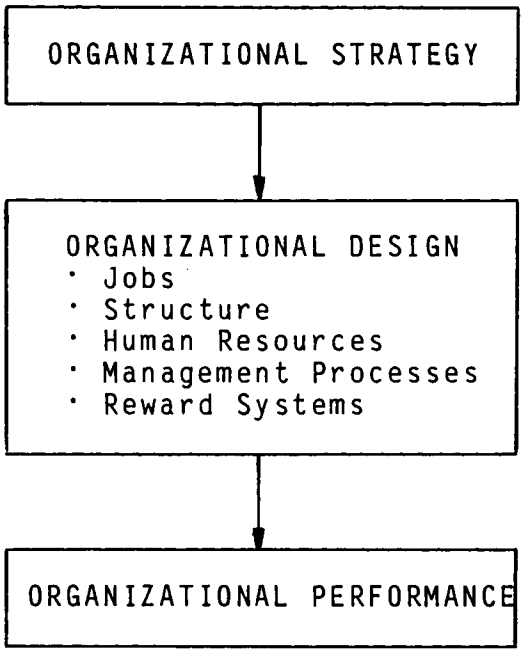


Figure 2.3. The Relationship Between Strategy, Design, and Performance of an Organization.

Source: Adapted from Jay R. Galbraith and Daniel A. Nathanson, Strategy Implementation: The Role of Structure and Process. New York: West Publishing Company, 1978, p. 2.

design, and performance. While Galbraith and Nathanson did not suggest including reward systems as part of a strategic management model per se, they did acknowledge that it is necessary for a firm to attempt to have system congruence and to look for the best reward system for that particular organization considering "task, strategy, structure, processes and other systems" (24, p. 81). The designer of the reward system should be charged with ascertaining what behaviors are necessary for the firm to implement a successful strategy. Again, from the model, the interaction between the design variables will affect the implementation of a firm's strategy and ultimately its performance.

Stonich (71) postulated that efforts to improve strategy implementation through the combination of strategy formulation and resource allocation have not been as effective as they could have been because the performance measurement and reward system has often been omitted in the planning and execution of the strategy. It is in the company's best interest to recognize that some mechansim is needed to encourage managers to pursue actions that are consistent with the achievement of strategic objectives. Like Lorange and Galbraith and Nathanson, Stonich regarded the measurement and rewards system as a subset of several key variables influencing managerial behavior; yet, the management and rewards

system is incapable in and of itself of being the sole motivator of managerial actions. Every organization should have a unique set of key variables which should produce a correspondingly unique measurement and reward system, even when the business environment and industry practices are considered.

The four key variables in Stonich's model which influence managerial behaviors are organization structure, human resources, culture, and management processess (see Figure 2.4) (71, p. 47). Since these variables are interactive, the ultimate success of the chosen strategy is affected by all of the variables and their interactions in this model.

In Figure 2.5, Stonich shows specifically where a performance and reward system fits into the scheme of successful strategy implementation (71, p. 56). While cautioning that a performance and reward system cannot drive a successful implementation alone, it certainly can prevent a full measure of success from being realized. Firms create

> an economic environment where everyone is rationally responding to individual incentives which may be in direct conflict with the achievement of long-term strategic objectives (74, p. 78).

Gellerman confirmed this idea when he stated,

> The reward system of a company is always motivating its employees in some direction, and this is not always consistent with the direction in which the organization is trying to move (25, p. 32).

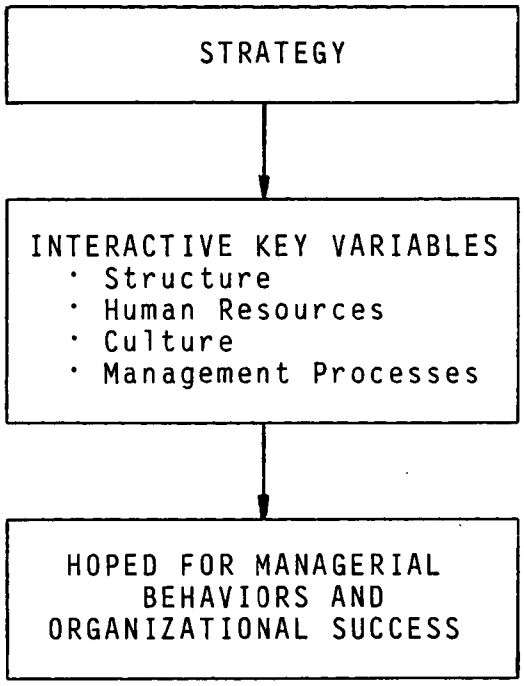


Figure 2.4. The Effect of Strategy and Interactive Key Variables on the Hoped-for Managerial Behaviors and Organizational Success.

Source: Adapted from Paul J. Stonich, "The Performance Measurement and Reward System: Critical to Strategic Management", Organizational Dynamics, 12 (Winter, 1984):47.

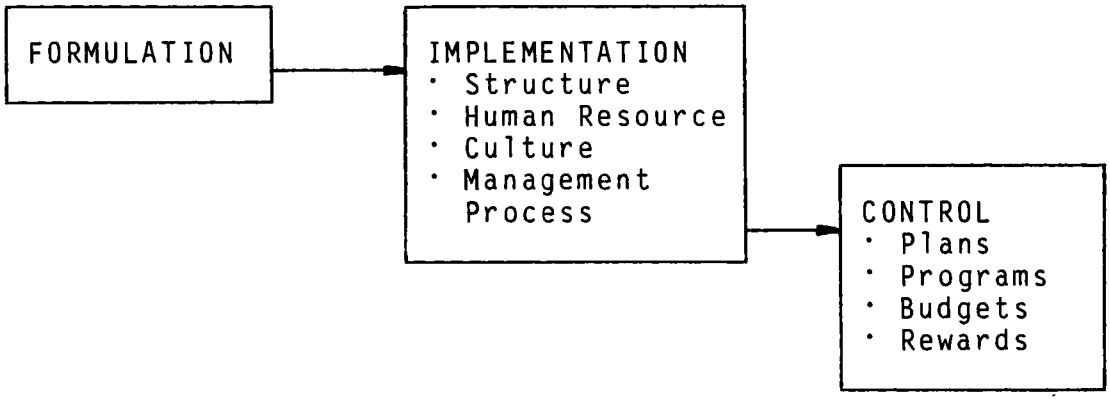


Figure 2.5. Rewards as Part of Implementation and Control in the Strategic Management Process.

Source: Adapted from Paul J. Stonich, "The Performance Measurement and Reward System: Critical to Strategic Management", Organizational Dynamics, 12 (Winter, 1984):56.

Prasad also included reward systems as a variable in his conceptual model of the strategic management process (see Figure 2.6) (53, p. 6). After the choice of the appropriate strategy has been made, the structure and reward systems must be reviewed and budgets developed. Both the strategy of choice, and the structure/reward system directly influence the functional strategies and implementation (53, pp. 6-7). He considered the compensation system as a "vital instrument for rewarding and motivating management" (53, p. 143).

Long-term incentives are increasingly being adopted to reflect the concern of top management for the success of the strategic plan. Hopefully, this will stimulate middle managers as well to change their time horizon to include both long-term and short-term performance (53, pp. 143-144).

Summary and Conclusions.

While several writers in the area of strategic management acknowledge the fact that rewards do affect the outcome of strategy, the authors discussed in this section regard the impact of rewards on strategy as significant. In each model presented and discussed, the positioning of rewards in the model indicated that strategy outcomes will be altered by the reward system. Even Galbraith and Nathanson's model which is primarily concerned with structural components, clearly illustrated the fact that

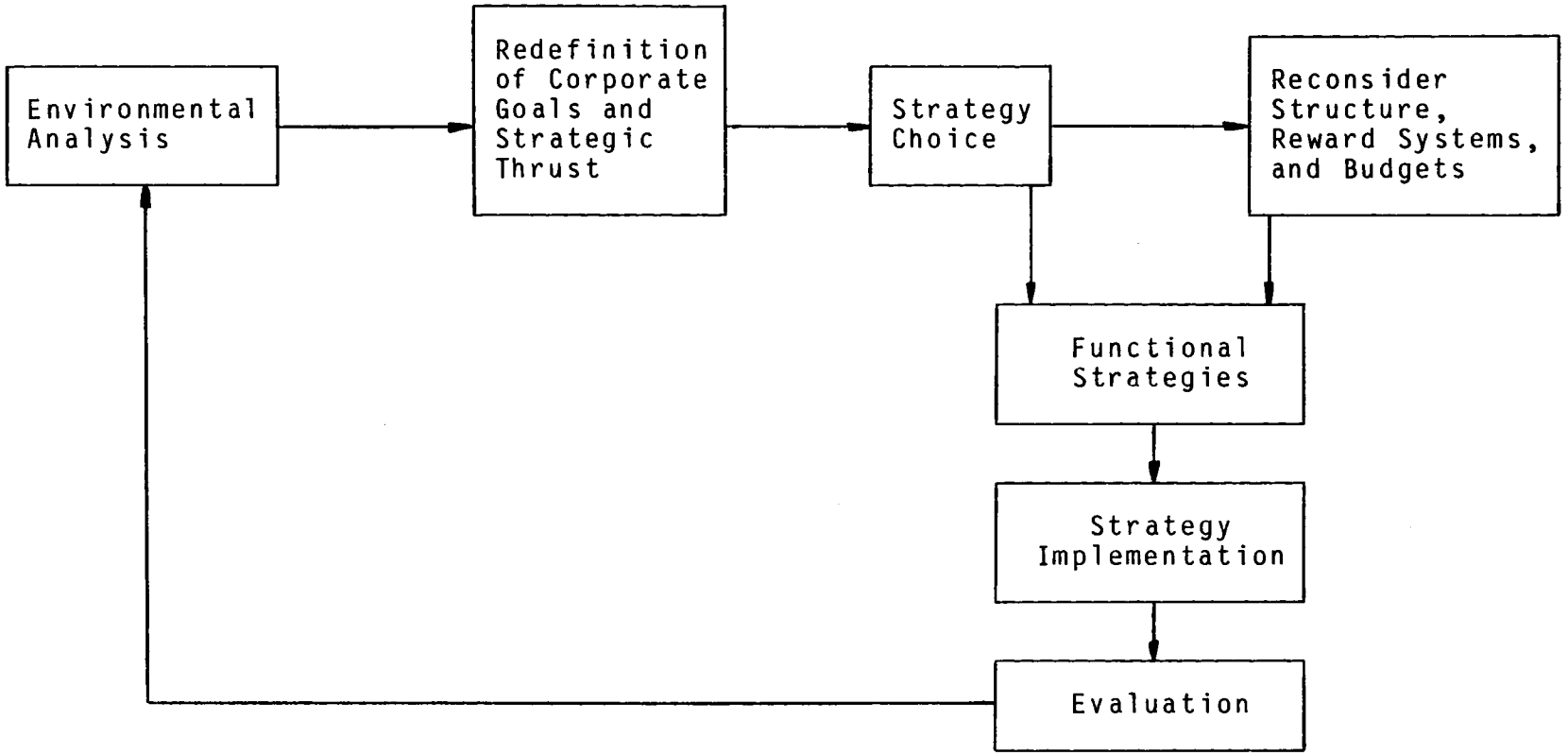


Figure 2.6. A Condensation of a Conceptual Model of the Strategic Management Process Showing Reward Systems As a Variable.

Source: Adapted from Benjamin S. Prasad, Policy, Strategy, and Implementation. New York: Random House, Inc., 1983, p. 6.

the reward system, as a major organizational design variable, will directly impact organizational performance.

Although these models are intended to be illustrative samples of those available which incorporate rewards as a variable, the number of such models is not overwhelming. Earlier strategic management literature did not dwell on the behavioral components of the planning process, and this was manifested in the lack of regard for these components in the models and subsequent discussion of them.

The current consideration of the reward system as a model variable indicates a growing recognition by strategic management experts that certain aspects of human behavior must be recognized and dealt with in this rational process called strategic management.

Rewards or Incentives as a Consideration in Strategic Management

This section discusses the viewpoints of authors who recognize a relationship between the reward system in an organization and the strategic management process in that organization. While these authors did not include incentives in their models, they did discuss the importance of incentives with respect to one area of strategic management. How important the reward system is and what part of the strategic management process is affected differs from one author to the next.

Tate and Taylor considered rewards systems as feedback mechanisms of control, and control was considered to be part of implementation. They stated an overriding principle to be that

> the data gathered must be used to justify the rewards allocated, and the rewards must be designed to fit behavior consistent with organizational goals, strategies, and policies (72, p. 58).

When developing the executive compensation system, this fit is severely tested, particularly because it is subject to the vagaries of the changing tax laws and Internal Revenue Service (IRS) regulations, which make it very challenging to develop long-term incentives to fit the long-term aspects of the strategic plan. Tate and Taylor stated that executive compensation systems are developed over the years, change incrementally, and are short-term in focus; all of which present additional problems. They recommended using the Boston Consulting Group matrix and the product life cycle approach to develop measures which are more meaningful than one set of common measures applied to all managers and executives (72, pp. 58-59).

In order to obtain commitment to the strategic plan that virtually extended to all individuals in the organization, Thompson and Strickland believed that the reward structure must be linked to actual strategic performance (73, p. 244). Specifically, the actual strategic performance and the reward structure must have

tight, explicit linkages. Identifying and developing these linkages is regarded as an administrative task in implementation. Additionally, it is vital that managers are advised as to how their rewards are determined, and that once the objectives are established, they must be adhered to in order to let managers know what sort of behavior is really being sought and rewarded.

Although Byars indicated the reward system is one of the most effective motivational tools available to the organization, there is also the possibility that the reward system could work counter to successful strategy implementation (8, p. 213). Two major problems identified in the design of most management incentive pay programs are: (a) failure to consider the performance of the individual as compared to the performance of the industry; and (b) the tendency to overemphasize the measurement of one aspect of the firm's performance while ignoring the measurement of other aspects completely (8).

Pearce and Robinson discussed the link of the reward system to objectives, implementation, and evaluation and control (50). An effective process for controlling and evaluating strategy execution needs to be established. "Integral to this control and evaluation is the need for a reward system providing the motivation for evaluation and the feedback to encourage effective control" (50, p. 360).

To establish an effective control and evaluation system for strategy, three basic elements must be included:

|1| Establishing control systems based on performance standards that are linked to annual objectives,

|2| A way of monitoring performance and evaluating deviations, and

|3| A means for motivating control and evaluation (50, p. 360).

Furthermore, they discussed the most important factors in the effective implementation of strategy as both motivating and rewarding the outstanding performance of individuals and units in an organization (50, p. 375). The three components of rewards and sanctions for individuals are financial, intrinisic (non-financial), and negative sanctions (50, p. 376).

Because developing and utilizing only short-term goals presents some major problems, consideration and measurement of both long-term and short-term goals are necessary. Focusing on the short-term is concentrating on the recent past rather than the future. Although accounting measures do not consider strategic (future) gains and losses, major transactions do have both immediate and future impacts. Finally, the exclusive use of short-term goals means time and money invested for future benefits can have a negative impact on current year bonuses (50, p. 360).

To avoid these pitfalls, the achievement of both short-term and long-term goals should be rewarded. The

balance between the time horizons and the type of performance measures used should be dependent on the strategy being employed.

The relationship of compensation to the formulation of objectives and evaluation was discussed by Bates and Eldridge. Objectives should specify means as well as ends to alleviate the problem of reaching short-term goals by foregoing certain necessary investments or purchases needed for long-term survival. Under evaluation, there is a need for a direct link between the attainment of mid-range and long-term objectives and the bonus incentive plan (4, pp. 250-253).

Newman, Logan, and Hegarty (46) discussed executive motivation as generally affecting strategic management. Four different types of executive motivations were discussed. The first type was financial rewards. Money does matter, and is a "crude measure of success in our society" (46, p. 547). Salary is a non-variable component of executive financial rewards; however, those components which are variable "should be used courageously as rewards for outstanding achievement of strategy" (46, p. 547). The second type was the inner sense of achievement. Management cannot grant this reward, but it can create the climate conducive for achievement. As a third type, social status and recognition was a motivating factor that is satisfied through symbols of the office and various

prerequisites. Fourth, power and influence were motivators to some, but not all, executives (46, p. 547).

Summary and Conclusions.

In conclusion, these authors considered executive and other compensation systems to have a direct influence on implementation of strategy. Corporate objectives should be reflected in what individual executives are expected to accomplish, and evaluation of performance should reflect the degree of achievement of these objectives. In a general sense, several of these authors agreed that choosing appropriate reward measures was both difficult and necessary. Both means and ends should be examined when determining performance.

Underlying the inclusion of reward systems into strategic management models, and the discussion of the effects of reward systems on various other models, is an implicit assumption about motivation theory. None of these authors mentioned or discussed a "best theory" of motivation related to executive pay.

Motivation Theories

In the previous section, several authors noted that reward systems can and do influence the behavior of executives and top management. Although none discussed or defined motivation explicitly, some did refer to Lawler's classic work on pay (36). This lack of a specific

discussion concerning motivation leads to the conclusion that most strategists who discuss reward systems rely on what Lawler terms the "'common sense explanation' of motivational phenomena" which can be characterized as "'X is working hard in order to earn more money'" (36, p. 80). While this is intuitively appealing, it does not explain performance. To do that, a theory must explain both why goals are sought and the factors that influence how they are sought (36, pp. 80-81). The major motivation theories which warrant consideration are: drive theory, expectancy theory, equity theory, and the two factor theory (see Table 2.1).

Hull was responsible for the development of drive theory, which he claimed could be used to explain present behavior (31). The formula which represented his theory, ${}_{S}E_{R} = \sum f\ ({}_{S}H_{R})\ x\ f\ (D)$, was designed to calculate the impetus to respond by multiplying habit strength by drive (36, p. 84).

Drives were assumed to be partially responsible for energizing and directing the individual. The strength of the drive(s) increased as the time of deprivation increased. The type of drive determined the behavior(s) that resulted; in other words, the proper behavior was directed by the drive.

Habit strength was thought to build up gradually over time through the reinforcement of the connection between a

Table 2.1. Major Theories of Motivation.

Theory	Major Proponent	Formula	Pay Motivating
Drive	Hull	Reaction Potential = Habit Strength x Drive	Yes
Expectancy	Vroom	Force = $\sum$(Expectancy x Valence)	Yes
Equity	Adams	(Self)$\frac{\text{outputs}}{\text{inputs}} = \frac{\text{outputs}}{\text{inputs}}$(Other)	Yes
Two Factor	Herzberg	Motivators Hygiene Factors	No

certain stimulus and response. Based on this fact, drive theory has been characterized as being rooted in past behaviors. Due to criticism by others in the field, Hull revised his theory to accommodate research which suggested that a positive or negative change in the size of a reward might affect behavior immediately. Because of this revision by Hull, the distinction between drive theory and expectancy theory was lessened.

In relation to Hull's theory, pay can act as a secondary reinforcer. The ability of pay to motivate good performance is dependent upon the degree to which it has been associated with good performance in the past. According to this theory, it is former experiences and not anticipated events that will determine performance (36, p. 84).

Expectancy theory is based on the early work of Tolman and Kurt Lewin in the 1930's. This theory is based on two concepts: valance (attractiveness of an object) and expectancy (the likelihood that a certain action will lead to a certain outcome or goal), and the two are combined multiplicatively. Many expectancy theories have been developed and all of them are essentially based on the concept that

> the strength of a tendency to act in a certain way depends upon the strength of an expectancy that the act will be followed by a given consequence (or outcome) and upon the value of that consequence to the actor (36, p.88).

In 1964, Vroom's theory was derived specifically to deal with motivational considerations in the workplace, and was stated as "Force $=\sum(E \times V)$, where the summation is across all outcomes" (36, pp. 88,89). E equals expectancy and V equals valence, where valence is instrumentality times valence. Expectancy is defined by Vroom as the belief held at a particular time that certain acts will be followed by a certain outcome. Expectancy is strongest (1) when the act is sure to result in the outcome, and is the weakest (0) when the act is sure not to result in the outcome, as believed by the subject. Since either expectancy or valence could be zero, the resulting motivation may be zero as well.

Although there are several variations in expectancy theory, all expectancy theories have one area that is difficult to resolve satisfactorily, and that is the difference between acts and outcomes. The question is whether an outcome, such as pay, is seen as the goal or whether the performance itself is seen as the goal.

Another problem related to this difference between acts and outcomes has to do with the difference between trying hard to perform well and actually performing well. In the laboratory setting, they are considered the same but in many situations, such as in school or in business, they are not.

Finally, the degree to which pay and performance are linked is also important. In order to operationalize the theory, people must believe that pay and performance are strongly correlated (36, pp. 90, 91).

A less developed, but well-accepted theory of motivation is based on Adams' theory of social inequity. Adams defines inequity as follows:

> Inequity exists for Person whenever he perceives the ratio of his outcomes to inputs and the ratio of Other's outcomes to Other's inputs are unequal. This may happen either (a) when he and Other are in a direct exchange relationship or (b) when both are in an exchange relationship with a Third Party and Person compares himself to Other (36, p. 92).

According to Lawler, outcomes on the job are pay, fringe benefits, status, intrinsic interest of the job and inputs are education, amount of hard work, and other qualifiers for the job such as experience (36, p. 92). Equity is based on perception and not observable reality, and individuals will strive to achieve equity or reduce inequity according to how much of an imbalance the individual perceives.

Although Adams conducted research on pay inequity to predict a person's behavior for both overpayment and underpayment, his research tended to focus on inequity reduction through input changes such as productivity and work quality. Using his theory, inequity reduction can be accomplished through a change in the object of comparison,

leaving the area of comparison, and perceptually altering either inputs or outputs (36, p. 93).

When using equity theory to anticipate how subjects will react to overpayment and underpayment, Adams predicted different reactions for each depending on whether the method of payment was piece rate or hourly rate. His research conclusions were: (a) overpayment will always result in higher quality work. It will yield lower productivity in the piece rate setting and higher productivity in the hourly rate setting; and (b) underpayment will always result in lower quality work. It will yield higher productivity in the piece rate setting and lower productivity in the hourly rate setting.

Herzberg postulated that people's needs in the work place were of two basic types, motivators and hygiene factors. He was led to this conclusion as a result of his research which involved questioning a sample of engineers about what they found to be good and bad about their jobs. The results indicated that different job dimensions accounted for what resulted in a good or bad day at work. Hygiene factors emerged as salary, supervision, working conditions, interpersonal relationships, and company policy and administration. Herzberg believed these to correlate closely to the lower order needs identified by Maslow (40). In order for a person to tolerate the job, these hygiene factors would have to be at least

minimally acceptable. Motivators emerged as achievement, recognition, the work itself, responsibility, and advancement. Herzberg believed these to correlate closely with Maslow's higher order needs. These factors make people happy with their jobs and motivate them to perform better (3, p. 268).

Herzberg has conducted studies which he claims support his ideas. Herzberg's theory has gained relative popularity although many do not agree with his theory. Motivating people with money is not compatible with this theory.

Summary and Conclusions.

Four major theories of motivation have been presented and discussed. While drive theory and expectancy theory were historically related through development, equity theory and the two-factor theory seemed to be distinct in the concepts underlying them. Both expectancy theory and equity theory supported the notion that behavior could be altered through meaningful monetary incentives, while two-factor theory did not seem to support that notion.

One observation about these theories concerned the difficulty of measuring motivation in individuals when the theories were applied. If measurement difficulties were obvious in a controlled laboratory setting, these difficulties would be greatly compounded in an uncontrolled environment such as the workplace.

Each has its relative merits and faults. In the previous two sections, authors in the field of strategy never stated either a preference or a name for their beliefs concerning motivation. In the presentations of studies concerning managerial and executive pay in the following section, support for various portions of these theories of motivation will become evident. What is most evident is the lack of support for any one theory over the others. Motivating managers and executives is a complex task at best, and no one theory of motivation seems to provide an answer as to how to motivate executives in the workplace.

Studies Concerning Executive or Top Management Compensation

While one necessary component is having theory about the ability to motivate through rewards, another component is testing that theory to ascertain its usefulness in a given situation. The literature concerning rewards and motivation in the work place can be broken down into three general organizational levels: (a) lower level employees, (b) managers, and (c) upper level executives. While there is the most empirical testing of the first level, it is of the least interest to this study.

The second level covers the empirical studies whose subjects were managers and these studies are of more value to this study because upwardly mobile managers can be

expected to emulate executives more than lower level employees. Depending upon the population of the study, managers may have direct responsibility for the financial success and survival of a territory, region, product line, or group of stores. Nevertheless, the studies which are relevant in this category are small in number.

The empirical studies of top executives, the third level, including chief executive officers (CEOs), are also small in number. Of this group of studies, many are simply surveys of large, well known management consulting firms who devise executive compensation packages. The majority of these surveys have focused on whether or not firms are using some type of long-term incentives and whether or not CEO compensation varies with corporate performance. Clearly, the theoretical proponents of performance-contingent pay, particularly Lawler (36) and Gellerman (25) (for CEOs), have made theoretical contributions only, and have not tested their ideas empirically. Moreover, well respected, practicing compensation experts such as Patton (48), Rich and Larson (62), and Redling (58), have contributed to the literature primarily through surveys. Many of their contributions are anecdotal in nature. In conclusion, the body of literature is small.

The literature concerning pay for performance appears to fall in three categories. The first deals with the question of whether or not companies do pay for

performance. Many of these do not address the issue of the intent of corporations to pay for performance, but merely indicate whether executive compensation is related to some measure of performance or not. The second deals with the pay as a motivator. In other words, these studies are designed to test the commonsense motivational assumptions pervasive in American society, namely, that it is possible to improve executive or managerial performance through a pay for performance system. The third deals with strategic compensation studies. Although empirical studies are nonexistent, specific examples of corporations who are using it are available.

The major conceptual difference between pay for performance and strategic compensation planning lies in the intent of management or the board of directors to reward executives (and, in some cases, eventually all of management) for the achievement of both short-term and long-term objectives which are established directly as a result of the corporate objectives laid down during the planning process. Strategic compensation is unique to the company and flexible enough to withstand or accommodate external changes, having acknowledged the majority of influential internal and external variables which pressure the integrity of the system. While strategic compensation is a type of pay for performance, the distinctness of its conceptual base makes it the subject of this dissertation.

Pay for Performance Studies.

As in many fields of study, contradictory evidence exists for divergent opinions concerning certain issues. Because such a contradiction existed concerning whether of not firms do pay for performance, these studies are divided into two sections.

Evidence that companies are paying for performance.

Studies which show that companies do pay for performance are discussed in chronological order from the least recent to the most recent.

Executive compensation and company performance level data at three year intervals from the proxy statements of fifty identified industrial corporations from 1942-1963 were collected by Lewellen and Huntsman (54, p. 555). Executive compensation was defined as salary and bonus in one instance, and total compensation (salary, bonus, and all major contingent and deferred compensation) in another. The authors were testing the premise that executive compensation is related in a linear fashion to both profit and sales. Salary and bonus rather than total compensation yielded better results. While sales had no strong, consistent effect on executive compensation, company profits did (54, p. 555). When equity market value was substituted for profits, similar results were achieved.

In 1975, Murthy and Salter reported on the results of a survey of fifty-three CEOs who were in office for six or more years from 1960 through 1974 (45). The aggregate numbers did not support the pay for performance compensation system because 66 percent of the executives surveyed showed no statistically significant relationship between return on equity and changes in executive compensation, and 40 percent showed no significant relationship between earnings per share (EPS) and changes in executive compensation.

Murthy and Salter proceeded to classify the companies into three strategy (and subsequently, structural) groups. The first group was called dominant-business companies because their revenues came largely from a single business with an integrated manufacturing process and a variety of end products. The second group was called related-business companies as 70 percent of their total revenues came from related businesses, but no single business accounted for 70 percent or more. The third group was called unrelated-business companies because less than 70 percent of total revenues came from any single group of similar businesses. Each group was further divided into high and low performers.

Using these groupings, Murthy and Salter found support for the existence of pay for performance, but also found that it existed in different percentages in each of

the three basic organizational structures. They observed that unrelated businesses utilized pay for performance to a much greater extent than either related or dominant product companies, and that pay for performance was linked to financial measures in related and unrelated groups, especially EPS and profitability. The variability of total compensation from one year to the next was greatest in the unrelated group (100 percent), and the least in the dominant product group (55 percent). Murthy and Salter concluded that, for various reasons, pay for performance does exist, but exists unequally among companies with different strategies and concomitant structures (45).

In 1978, Rappaport reported that in the 1976 annual Business Week survey, bonuses for the top three executives of major corporations were closely related to earnings reported in the prior year (56, p. 83). However, this relationship may be distorted due to the highly leveraged bonus, which means that once a certain hurdle performance figure is passed, bonuses increase at a very rapid rate.

Foster (18) found that job worth (within a given firm), organizational size, and business results (performance), in that order, were the primary determinants of executive pay. Two hundred-eighteen manufacturers provided current base salary information for May, 1979 and bonus amounts paid in 1979 (but based on

1978 performance) for 16,200 executives from CEO to Quality Control manager. Compensation was standardized in each firm to allow comparisons across organizations. Companies were divided into four groups based on the sales figures. Within each sales group, cash compensation pay models were developed which accounted for 94 through 98 percent of the differences in total cash compensation of each executive. In addition to major findings, Foster also found that pay at higher levels of the organization is affected more by business performance, and that executives in better performing firms are paid more than executives in firms whose performance is not as good.

Kraus (35) quoted a 1978 McKinsey study of 100 companies that showed the average pay increase for the top fifty companies to be 18 percent, when ranked by percentage growth in annual profits, while the average pay increase for the bottom fifty companies was only seven percent. He pointed out that in many individual cases, there is no obvious relationship between short-term performance and top management pay.

In the 1970's, Rappaport reported that the transition from rewarding executives through stock options to rewarding executives through performance plans with three to five year goals had begun (57). As of 1981, of the 200 largest industrial companies, 82 had adopted such pay for performance plans.

In 1984, Rich and Larson reported that nearly 40 percent of the Fortune 500 companies had adopted some form of performance based, long-term incentive (62). (This was part of a larger survey which will be discussed later in this chapter.)

Young's annual study of executive compensation correctly predicted that salaries in the 1980's would make up a smaller portion of the total executive package, while performance variables would make up a larger portion (44, p. 42). The fact that these are performance based is substantiated by the finding that 27 percent of executives who received bonuses in 1981 did not receive bonuses in 1982. Analysis of companies in the survey revealed more consistency in the relationship between bonus pay and corporate performance.

The previous eight studies all supported the premise that corporations are currently paying executives more money when the performance of their firms either improves or is superior. The types of studies range from surveys to statistical analysis. Of the surveys included, a trend towards more performance based pay could be identified. Special note should be made concerning the Murthy and Salter study (45), because it confirms the relationship between strategy, structure, and performance based pay. Additionally, both the Murthy and Salter study (45), and the Foster study (18) support the idea that all systems

within an organization, including the reward system, should be considered simultaneously.

Evidence that companies are not paying for performance.

While a number of surveys indicate that companies do pay for performance either intentionally or coincidently, there is also evidence that companies are not doing so. The last three surveys discussed in this section support the idea that companies are claiming to use performance based measures, but in fact, are not doing so. Two studies which disprove the notion that companies are paying for performance are also presented.

In 1962, McGuire et al. (54) examined data for 45 unidentified large United States industrial corporations from 1953-1959 taken from Fortune and Business Week surveys. Income of the CEO for each of these firms (which included the market value of stock given to him/her) was identified for the years 1953-1959. Correlations were determined for relationships of executive income, sales, and profits. The results supported the idea that sales and executive income were "significantly correlated", while profits and executive incomes were not.

Prasad (54) used data from 823 firms of various types taken from Forbes. His emphasis on executive compensation was in the executive group rather than the CEO alone, because he believed that financial results of a large firm

Using a weighted regression model, he found a positive correlation between the variables of total renumeration for the top management group, sales revenue, net profits, and cash flow. While Prasad supported the thesis that executive compensation and profitability are correlated, he also found that sales and other unidentified variables were important determining variables in executive compensation.

Redling (58) took a random sample of 100 of the 1,000 largest firms in the United States. He devised a five year performance ranking which was to provide an index of both growth and profitability. The index was based on earnings growth and return on stockholder's equity. In order to remain in the sample, companies had to have the same Chief Executive Officer (CEO) through the duration of the study (1974-1979), and they had to have data available which provided information on base salary and bonuses separately. Of the original 100 in the random sample, only 25 fit both criteria. The five year performance figure ranked the companies from best performer to worst performer. The greatest salary growth during the period was 143 percent; the median growth was 14 percent. The CEO of the best performing company received a 25 percent increase, the worst performing company gave its CEO a 48 percent increase (58).

Since the correlation coefficient between percent salary increase and five year performance was only .16, the study did not support the existence of pay for performance. When the bonus figures were calculated into compensation, the correlation coefficient dropped to .09. Moreover, the average increase of salary plus bonus for the ten worst performers was 82 percent; while for the ten best performers, it was 86 percent. These differences do not indicate rewards for overall performance. Redling concluded that for CEOs, pay for performance is dubious (58).

Loomis (38) performed an analysis of executive compensation and corporate performance by comparing the 1981 return on stockholder's equity with the compensation paid to its CEO in that year for 140 companies in ten different, major industries. The compensation figures included:

> salaries, bonuses, profit sharing, stock-purchase contributions made by a company for a CEO's account, 1981 compensation that is scheduled to be paid on a delayed basis, and personal benefits such as financial counseling services and large life insurance premiums that are payable to the CEO's estate (38, p. 43).

Long-term income with an uncertain payment date was excluded from the calculation of executive compensation. Return on equity figures came from Fortune 500. Loomis' conclusion was that there is little to justify belief in pay for performance (38).

Patton (48) provided a scattergraph of sales (in billions) and compensation of CEOs (in millions) of the one hundred largest United States industrial corporations, which was constructed from proxy statements. The graph did not show any clear linear relationship between sales and compensation (48). What was evident was that CEOs of smaller companies received the largest income. This was supported by a Forbes survey which reported "that 70 CEOs of companies smaller than the 100 largest topped many company officers below the rank of CEO earned over one million dollars. In 1982, 55 of the 100 largest firms had lower earnings, but one-half of their CEOs received pay increases. In 1983, salary and bonuses increased for 81 of the 100, while one-third of the companies reported lower profits. Patton observed that pay for performance was not present in corporate America (48).

Summary and conclusions. The preceding five studies seemed to indicate that there are a large number of corporations not paying executives for performance. The conclusions of these studies are in direct opposition to several of those presented in the prior portion of this section. Several theories can be proposed to account for the obviously contradictory conclusions. Consideration of different industries, the emergence of huge conglomerates, the effect of foreign currency translation on the international firms, different strategies and proposed

strategies are just four factors among many which could alter the results of these studies.

What is more significant is the intent of the organization to pay for performance. This intent cannot be discerned in the financial statements, but could be discerned by examining qualitative data, and/or interviewing officers. Therefore, the only conclusion that can be safely drawn from this body of literature is the fact that some studies support and some experts believe that pay for performance is viable, while others find little evidence to support that belief.

Studies Which Discuss Pay As A Motivator.

This group of studies looks at pay for performance to see if rewards, primarily monetary, affect performance positively. Although performance-based incentives are theoretically compatible with many theories of motivation, not all studies indicate this is true. First, studies that do not support the idea that pay motivates will be discussed; second, a study that does support the idea that pay motivates will be discussed.

Non-supportive studies. While the primary purpose of Stieglitz's study was not to determine if monetary incentives can motivate executives, this study is often used as evidence against the motivational power of money. Stieglitz (70) studied the CEO and his/her job and

concluded that money was not an important motivator to the CEO because only one-quarter of the 300 respondents ever mentioned money as a satisfier (70, p. 30).

Another study, whose primary purpose was to determine the motivational value of money, was conducted at the managerial level of the Social Security Administration (51). The managers of 20 district and branch offices who were part of a merit pool constituted the individuals involved. A change in merit pay policy was initiated as a result of the Civil Service Reform Act of 1978. Prior to the passage of the Act, a pool of money was automatically awarded to managers as annual pay increases. Under the new system, half of this was awarded as before and half was allocated to a performance based merit system. Four performance indicators which were available for about two years prior to the inauguration of this study were chosen as variables. They were:

> (1) the average number of days for a retirement/ survivor's claim to be paid or denied...(2) the average number of days for a supplemental income claim to be paid or denied...(3) the percentage of supplemental income claims with accurate documentation...(4) the percentage of post entitlement actions that took over thirty days to be settled (51, p. 265).

These measures had become accepted performance measures and were not changed significantly after the introduction of the merit pay system.

A time series analysis was used over a four year period--two years prior to and two years after the

initiation of the merit pay system. The results of this study indicated that, in 11 of the 12 tests, there was no significant permanent effect, either positive or negative, on organizational performance. The time series took into account the fact that performance had been improving in the Social Security Administration for a substantial time period before the Reform Act was passed, and the merit pay system did not seem to have any additional effects. In conclusion, the merit pay system did not enhance organizational performance in the opinion of the authors.

A supportive study. This study indicated that monetary incentives not only motivated executives to do a better job, but also that the financial performance of the company was improved when monetary incentives were utilized.

In the executive compensation survey done by Peat, Marwick, and Mitchell (17), the profit performance of bonus paying companies was better than that of non-bonus paying companies. While the former group of companies which had instituted formal incentive plans had an average return on investment (before taxes) of 16.8 percent, the latter group of companies which had no formal incentive plan had an average return on investment (before taxes) of 11.7 percent. The after-tax profits were 8.6 percent and 6.0 percent, respectively. Firms which paid bonuses to their CEOs earned an average of 43.6 percent more profit

than firms which did not pay bonuses to their CEOs. Peat, Marwick, and Mitchell considered this to be important.

Summary and conclusions. In summary, studies indicate contradictory results regarding the ability of monetary incentives at the executive and managerial levels to motivate better performance. Interestingly, no studies could be found that showed whether rewarding for the short-term only could hurt performance.

Strategic Compensation Studies.

Strategic compensation studies are few in number because until recently very few firms were utilizing strategic compensation. Studies may also be limited in number due to the sensitive nature of disclosing executive and top management incentive plans.

The next study deals directly with the effectiveness of the long-term incentives which are performance based. A telephone survey of 74 major United States corporations in either the Fortune 200 or Fortune 50 was conducted to determine the current long-term compensation plan and any anticipated changes in these plans due to the results of the plan up to the present (62, p.28). Usually the interview was with the most senior compensation officer. Questions centered on the process of setting targets and the method of communication used to tell participants about the targets.

In aggregate, shareholders in companies without any long-term incentives averaged 7.8 percent return on investment from 1977-1982, while shareholders in companies with long-term incentives averaged only a 6.0 percent return. Dissatisfied with the results, Rich and Larson identified six firms with long-term incentive plans that: (a) measured both return on equity and growth; and (b) used a "systematic approach to setting and communicating plan targets" (62, p.32). These companies had an average return to shareholders of over 12.0 percent.

Rich and Larson concluded that certain major failings in most long-term incentive plans were one or more of the following: (a) the achievement of short-term goals provided too much of reward such that long-term goal achievement was thwarted; (b) use of an improper measure of financial success, particularly reliance on EPS singularly; and (c) performance targets of actions called for in the strategic plan being set without regard to company financial forecasts or results obtained at other firms in the same industry (62). In conclusion, they felt that strategic compensation was not without problems, but if these problems were handled adequately, the financial results would show that pay for performance can work for the short-term and the long-term.

Many compensation experts believe that linking executive compensation to strategic management is

motivationally sound, and will tend to ameliorate some of the forces which currently impinge or threaten to impinge on executive compensation practices (26, 29, 35, 42, 61, 62).

In 1981, Higgins conducted a study which gave some information about the idea of strategic compensation planning (29). He focused directly on the perceptions of 189 executives (CEOs, chief planning officers, and general managers at both the corporate and divisional level) in 86 companies out of a random sample of 112 Fortune 1000 firms. A questionnaire was used to ascertain if the companies had an

> explicit policy for recognizing contributions to strategic planning (as part of the performance appraisals of key line managers) and, if so, what weighting was given to these contributions. CEOs and planners were also asked to list the performance criteria they used to evaluate contributions of key line managers to the firm's strategic planning and to evaluate the importance of each of these.
>
> General managers were asked if they had ever been recognized for their contributions to strategic planning. They were asked to describe the nature of these rewards and to evaluate their adequacy (29, p.78).

Of the 86 responding firms, 54 had a strategic plan in operation. Approximately one-fifth of these had a formal, express policy of rewarding line managers for contributions to strategic planning. Of companies that had had planning systems nine years or more, 90 percent reported that they rewarded line managers through a formal process.

While many managers who had not been rewarded for their contributions to strategy said it was unnecessary, those who were rewarded rated their contributions to strategic planning higher. Furthermore, those who were rewarded rated their satisfaction with their participation in strategic planning and with the results of the strategic planning as very high or extremely high. In both of the latter instances, the results were statistically significant.

In conclusion, Higgins felt that appraisal and incentive systems have the potential to link individual managers to strategic planning, convey the importance of long-term objectives, and show that actual management practices are more important than company pronouncements with regard to the motivation to act (29).

Summary and Conclusions.

In summary, three types of studies have been examined relevant to executive compensation: (a) whether or not companies pay for performance in practice; (b) whether or not pay can motivate performance; and (c) the possibility of linking strategic management to executive compensation in an effort to align personal executive goals with corporate goals for the sake of strategy. One of the major problems with most of the studies stems from the fact that many variables are not recognized which have great influence on the operation of the executive

compensation system. These variables or factors have been identified in part through studies and theoretical writings of many authors. In the next section, the major variables which impinge on the construction and administration of the executive compensation system will be presented and discussed.

Major Factors Affecting Compensation

The factors which affect compensation can be divided into those that are external to the firm and those that are internal to the firm. While the number and importance of the external factors has grown over the past decade, the internal factors have changed primarily in response to the increased size and complexity of today's organizations. Some of these factors have only been postulated, while others have been systematically identified and their relative importance studied through research. Major external factors are discussed first; major internal factors are discussed second.

Major External Factors.

Just as organizations have learned to monitor external environmental factors which affect their longevity and financial status, those who design and administer executive compensation plans have had to recognize and contend with forces largely outside of their control. Differences in industry and changing tax laws

are standard variables to consider. Others, such as competition, inflation and potential government intervention have only recently become problems for corporations. The variables are discussed in random order in the following paragraphs (see Table 2.2).

The first major variable which affects executive compensation is the industry in which a company does business. Looking at the major surveys published today, compensation for different industry groups is quite varied. The Conference Board's 1985 Executive Compensation Survey is divided into eight major industries (23). Not only are the levels of compensation different, but the extent to which certain nonfixed portions of total compensation are used, varies by industry as well (44, 49). The annual Executive Compensation Study (44) also utilizes the industry breakdown to present findings. Loomis' study on executive compensation broke the data down into ten industries (38). In conclusion, there are obvious differences between base salary levels and the type and extent of variable components of total compensation used in different industries.

A second variable that affects executive compensation is change in the tax law. Periodicals widely read by executives such as Forbes, Fortune, and Business Week provide coverage about the possible effects of impending changes in tax laws and how they will impact executive

Table 2.2. Major External Factors Thought To Affect The Executive Compensation System.

Factor	Author	Study[a]	Year	Source
Industry	The Conference Board	Yes	1985	Top Executive Compensation
	Financial Executive	Yes	1985	Financial Executive
	Loomis	Yes	1982	Fortune
	Patton	No	1972	Harvard Business Review
Tax Laws	Kessler	No	1985	Fortune
	McMillan & Bruno	No	1983	Financial Executive
	Redling	No	1982	Personnel
	McLaughlin	No	1981	Management Review
Competition	Williams	No	1985	Fortune
	Patton	No	1985	Harvard Business Review
	Greene & Roberts	No	1983	Personnel Administrator

Table 2.2. (continued)

Factor	Author	Study[a]	Year	Source
	McLaughlin	No	1981	Management Review
	Kraus	No	1980	Harvard Business Review
Inflation	Patton	No	1985	Harvard Business Review
	McLaughlin	No	1981	Management Review
	Weeks	Yes	1976	Conference Board

[a]Under the column Study, "Yes" indicates that the author of the study supported the variable through research. "No" indicates that the author of the study believed the variable to be important, but did not conduct research to support that belief.

pay. Practitioner periodicals such as Management Review, Personnel Administrator, and Compensation Review do the same. Changes in tax laws result in a scramble by corporations to find other ways to compensate executives. McLaughlin (42) pointed to changes in tax laws as one main reason for the divergence of strategic planning and executive compensation practices.

A third variable is that of competition between corporations to maintain their desired position in terms of how well they pay. This has become an important variable due to the proliferation of surveys which provide averages. Most corporations do not want to be perceived as average. Because widely available published compensation surveys may lead to unwarranted increases in executive compensation, Patton believes the surveys to be the most important factor in rising compensation (49).

Since the rate of inflation has slowed, it is currently less of a major disruption of sound compensation systems, but is, nonetheless, a fourth major variable considered when determining increases in a given year.

The cost of living has increased 124 percent between 1973 and 1983, which means that "the $300,000 median 1973 cash compensation for chief executives of these big companies would have risen close to the $700,000 level in 1983" (49, p. 57). McLaughlin considered inflation the second major factor in the divergence between strategic

planning and compensation systems, and stated that companies were more concerned with keeping their executives "whole" than anything else (42). When inflation was very high in 1973-1974, companies also had to contend with wage controls and a recession, which greatly compounded inflation effects and presented unique problems to be solved in all employee groups (77).

While there are other external factors that may influence the construction and operation of the executive compensation system, such as geography or radical changes in technology, the four most frequently mentioned or alluded to were industry, competition, tax laws, and inflation.

Major Internal Factors.

While internal factors have always played an important role in determining executive compensation, the identification and monitoring of these factors has been more recent. In a sense, the internal factors act as constraints on the design and administration of executive compensation. The internal factors which affect executive compensation systems are size of the firm, culture, strategy (and resulting structure), and financial restraints, and they are presented and discussed in random order in the following paragraphs (see Table 2.3).

The fact that the size of a firm greatly influences executive pay is easily demonstrated by its acceptance by researchers in the area of executive compensation. Sibson

Table 2.3. Major Internal Factors Thought To Affect The Executive Compensation System.

Factor	Author	Study[a]	Year	Source
Size	Fox	Yes	1967	The Conference Board
			1976	The Conference Board
			1985	The Conference Board
	Foster	Yes	1979	Compensation Review
	Sibson	Yes	1971	Nation's Business
	Prasad	Yes	1972	Academy of Management Journal
	McGuire et al.	Yes	1953	Academy of Management Journal
Culture	Cummings	No	1984	Organizational Dynamics
	Stonich	No	1984	Organizational Dynamics
	Ungston & Steers	No	1984	Academy of Management Journal

Table 2.3. (continued)

Factor	Author	Study[a]	Year	Source
Strategy/ Structure	Kerr	Yes	1985	Academy of Manage-ent Journal
	Murthy & Salter	Yes	1975	Harvard Business Review
	Patton	No	1972	Harvard Business Review
Financial Constraints	None			

[a]Under the column Study, "Yes" indicates that the author of the study supported the variable through research. "No" indicates that the author of the study believed the variable to be important, but did not conduct research to support that belief.

(69, p. 30), reporting on the results of his firm's 1971 survey began by indicating that, as found in prior years, there is a correlation between salary level and the size of the company. The Conference Board surveys on top executive compensation always report the composition of their samples by industry and by size.

Many of the research studies discussed earlier had their focus on the discovery of factors which determined executive pay. A large number of these studies indicated that executive compensation appeared to be far more associated with size of the firm than measures of performance (54). McGuire, et al., Prasad, and Foster showed that size was one of the significant determinants of executive pay (18, 54).

There is also a general acceptance of the appropriateness of such a size-pay relationship. Because the responsibilities and risks increase with a larger firm, executives should be paid more for that larger risk and responsibility. While compensation experts agree with the soundness of this argument, Rappaport pointed out that this fact may fuel growth for growth's sake alone, even when it may be economically or strategically unsound for that particular firm (57).

The culture of the corporation also plays an important role in determining executive compensation. Although culture would appear to be an obvious source of

variation between companies' compensation plans, the literature on this topic is scarce, and what literature exists is not empirical. Stonich discussed the inconsistencies between measurement and culture, particularly as it applies to a major change in strategy. He postulated that the reward system can shape an organization's culture, but that is a long-term process (71). Cummings supported Stonich's theory concerning the necessity of changing culture over the long-term through the balancing of the system components (10).

Ungston and Steers offered a slightly different perspective in that they recognized the complexities of the CEO role and how these complexities relate to compensation. The culture of a firm will have great impact on the three perspectives of the CEO and politics in a firm as defined by Ungston and Steers, which are "(1) the CEO as a political figurehead; (2) the CEO as a political strategist; and (3) the CEO and executive succession" (76, p. 316). They offered four propositions which they felt were plausible intervening variables between CEO rewards and performance, which include:

Proposition 1: CEO rewards may be more of a function of political than of economic variables.

Proposition 2: Changes in CEO rewards are time related and often difficult to quantify.

Proposition 3: Studies of CEO compensation ignore important intangible features of the job.

Proposition 4: CEO rewards might better be understood in the context of the CEO's relationship with the board of directors (76, pp. 318-320).

The politics of any firm are part of the organization's culture, and will have a bearing on the type and level of compensation offered to top management.

The strategy that an organization uses, and structural changes that follow, will affect executive compensation. One group of studies indicated that there is a difference in the type of compensation used in dominant-business companies, related-business companies, and unrelated-business companies (45). A variation of this same theme was found in a discussion of industries that seemed to naturally fit the use of decentralized organization where decisions directly affect profitability (49). The essence of these studies showed that firms involved in conglomerate diversification have various businesses in unrelated industries with products at different levels of maturity. It may be easier to justify differences in compensation under these circumstances because quantitative and objective figures can be derived as measures of pay. In related-business companies there is more interdependence; therefore, responsibility becomes more diffuse. Contributions to strategy are more difficult to single out and measure.

One study showed possible motivational problems in unrelated- and related-business companies that stemmed

from utilizing non-growth strategies. This problem was ameliorated somewhat by designing the reward system to reflect conformity with the strategy designated for an SBU by corporate management (27).

A recent study by Kerr concluded that it was not the type or degree of diversification that determined the structure of the executive reward. Instead, his results indicated that it was how diversification had been achieved that determined the evolution and ultimate determination of the managerial reward system at any given point in time (32). From these studies, two factors emerge which affect the reward system, the type and extent of diversification and the process by which diversification was achieved.

There are no studies which state or discuss the use of financial restraints on compensation, but corporations do use forecasts to predict resources available to them in a given period and they use budgets to forecast expenditures. Financial constraints do exist, undiscussed and unrecognized as they may be. In years of either high inflation or recession or both, financial constraints become more acceptable topics with regard to top management compensation.

While in the past corporations tended to regard compensation as a closed system relying primarily on internal information for design and administration, this

is impossible today. Although size, culture, strategy (and structure) and financial condition act almost as given parameters in which the organization must operate, external factors serve to confound the best of systems. Instead of reacting to changing tax laws and inflation, for example, companies have started to monitor those external variables that affect compensation.

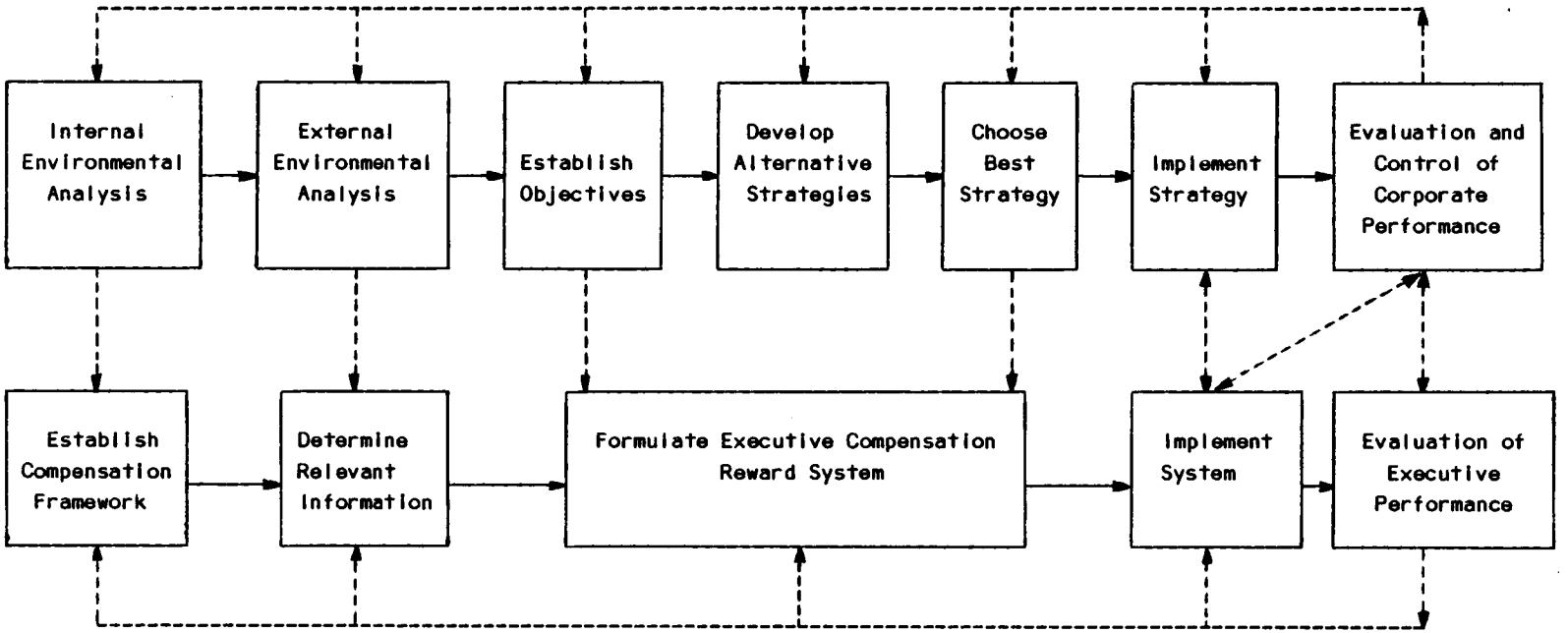
What makes an already complex topic more complicated is that all firms have a different set of factors affecting them at one time to differing degrees. These factors will be discussed again in the theoretical model presented in the next section.

The Theoretical Model

The theoretical model links strategic compensation planning and strategic management (see Figure 2.7). As the model shows, the upper portion represents a generic strategic management process. All of the generally accepted aspects of the strategic management process were incorporated into the model. A generic model is thought to be more appropriate than a specific model because it provides maximum adaptability for application. In other words, this model attempts to provide a framework upon which specific strategic management processes may be fitted.

The Strategic Management Process

--- information flow
___ action flow



The Strategic Compensation Process

Figure 2.7. Theoretical Model of the Relationship Between Strategic Management and Strategic Compensation Planning.

The lower portion of the model illustrates how the strategic compensation process is thought to be related to the strategic management process and how the strategic compensation process itself is postulated to operate. Neither a similar model nor a model depicting this proposed relationship could be found in the literature. Therefore, the model proposed at this point in the study is tentative although rooted in theory. Data collected from firms utilizing strategic compensation may provide information which would alter this theoretical model.

The key on the diagram indicates two types of activities occurring. The action flow is intended to depict some type of activity that has taken place. For example, someone must gather facts and make forecasts about the external environment. These facts must then be utilized when someone (or a group) proceeds to perform an environmental analysis.

The information flow is intended to show how communication flows between and within each process. Theoretically, the strategic compensation process depends entirely on information generated by the strategic management process. This is consistent with the idea that all systems must fall under the purview of the strategic management process. For instance, the control system in the strategic management process should provide information on interim checkpoints towards the achievment

of long-range goals. A strategic compensation system should utilize that information to determine an executive's performance with regard to the achievement of those long-range goals.

Internal Environmental Analysis.

The four variables--size, culture, strategy (and resulting structure), and resource limitations--were chosen to represent givens or constraints which will impact the entire planning process and subsequent strategic management of the firm. While all firms have these four constraints, the specific content of each constraint will be unique to every individual firm. Further, the identification of these four variables does not preclude either the existence or the identification of other important internal variables. These four variables have been identified through the literature as being important.

These four factors also directly impact the strategic compensation process as constraints. For example, resource limitations prevent designing a system that the company cannot afford. Culture may preclude giving certain prequisites except to individuals in specific positions. A divisional structure may indicate that more quantitative, objective measures of performance are available than with a functional structure. The size of the organization may determine the peer group for which the comparison of pay packages is made.

As indicated in the model, relevant information gathered during internal environmental analysis is utilized to establish a compensation framework. This framework consists of a base of information which will be utilized in the formulation of the actual reward system. To illustrate, recognizing impending major structural changes in a firm will signal a need to alter the compensation framework. This change would be identified during the internal analysis of the firm, and the information concerning this change will be transmitted to those in charge of the design of the strategic compensation process.

External Environmental Analysis.

The environmental analysis requires an examination of the current and the future status of variables which impinge, both directly and indirectly, upon the achievement of organizational objectives. The internal and external variables must be considered in order to match what it is organization wishes to do and what the company is capable of doing, both now and in some defined future period.

Part of the information gathered in the environmental analysis has direct bearing on the executive compensation system. Major industry changes could affect both strategy and compensation. Tax law changes may affect the profitability of an organization as a whole, while also causing a readjustment in the executive compensation plan.

Inflation information is ordinarily a key economic variable considered by corporations engaged in strategic planning and likewise, has great relevance in the formulation of compensation plans. To give a specific example of the relationship between the external environmental analysis and the determination of relevant information, consider how the Arab oil embargo of 1973 curtailed profits in the plastics industry due to high prices and general unavailability of crude oil at that time. In this case, information about the natural resources segment of the external environment, gathered during the environmental analysis, is very relevant to the design and administration of the executive compensation system. In such a situation, the individual goals for executives and the organizational objectives for the company may have to be reformulated to reflect a changed external environmental condition largely beyond the control of management.

To summarize, the environmental analysis information serves to provide the compensation system experts with information at regular intervals and at a time of abrupt change in any important variable.

Establishing Objectives.

Once the organization has identified the internal and external variables of importance to it, organizational objectives can be established. While some of these

objectives are short-term, the use of strategic management by definition, indicates that mid-range and long-term objectives also are established. Although short-term objectives are usually considered to be those to be accomplished in less than one year, and long-range objectives are those to be accomplished in five years, many factors can alter these general timeframes. For instance, deregulation in the airline industry has compressed the timeframe. Long range now would be closer to three years than five. Other industries, such as mining, may perceive the long-term to be twenty years.

Once corporate objectives are formulated, then the executive compensation system should have this information to establish goals for executives in given areas of responsibility. The exact mechanism for the transfer of the pertinent information is expected to vary from firm to firm; however, the crucial matter is that some recognized mechanism does exist.

The Development and Choice of Strategy.

The development of alternative strategies to reach organizational objectives is necessary for several reasons. First, many firms now use different scenarios to describe what is possible in the future. Each scenario may require a different strategy to reach desired goals. Second, some firms encourage the discussion of creative approaches for reaching goals in order to hinder using

past strategies merely because it is easier to do so. Third, firms in extremely turbulent environments may wish to have several alternatives on-line to reduce response time.

In a few circumstances, there may be a reason for the compensation system to be ready to respond to rapid strategy changes and therefore have the burden of handling multiple alternatives. Normally, though, the chosen strategy is the one which should be communicated to those responsible for the formulation of the executive compensation system.

Knowing how objectives are to be met is as important as the objectives themselves. In essence, this statement embodies an important philosophical difference between compensation and strategic compensation. The latter implies that objectives will be met through the deliberate execution of the chosen strategy. Meeting objectives through a deleterious strategy would not be in keeping with the idea of strategic compensation, and should not be rewarded.

Implementation and Evaluation and Control.

The model links the last two phases of each system very closely. When the corporate strategy is implemented, the executive compensation system should be implemented as well. Once implementation has begun, the evaluation and control mechanisms should be functional.

While certain short-term goals are easily measured, long-term goals should have interim checkpoints which signal that sufficient progress has or has not been made in a given interim. These checkpoints for corporate performance should also provide information about executives' performance. For example, if a corporate goal were to be in compliance with all OSHA regulations in five years, then specific portions of these regulations would be accommodated over the five year period, and individual executives would have responsibility for compliance as prescribed in the corporate strategy.

Just as control systems for strategic management must be as simple and as effective as possible, the same applies to the compensation system. Knowing what to measure, how to measure, and how often to measure is the key. Picking these measurements carefully could serve as a simultaneous check for the performance progress of the company and of the executives.

Feedback.

In any system, allowance must be made for adjustments from changes in the system. Both the strategic management process and the strategic compensation system must have the flexibility to handle changes.

While some companies have developed "war rooms" and other mechanisms to respond rapidly to changes, rapid alterations in the executive reward system may be less

feasible. Many executive plans are contractual, and can not legally accommodate changes even when warranted. Additionally, some companies' by-laws require shareholder approval for changes in the top executive plan; thereby limiting flexibility.

At a minimum, the strategic compensation system should allow for an information gathering feedback system, which could be used to recognize necessary future changes.

Summary.

What makes strategic compensation systems different from other compensation systems is the intent of management to acknowledge and reward the accomplishment of objectives--both short-term and long-term--through the judicious application of the chosen strategy. Inherent in this statement is the acknowledgement that the compensation system can and does motivate executives in some way, whether beneficial or detrimental, to the long-term survival of the firm. Implicit, also, is the recognition that compensation is not an issue that should be determined without strategy implications.

Summary and Conclusions

Increasingly, strategists have begun to recognize the importance of motivation on the formerly all-rational strategic management model. This recognition is evidenced by the increasing inclusion of rewards or incentives

systems in strategic management models and discussion of theory behind the construction of these models. Presented in this chapter were illustrative models by Lorange (39), Galbriath and Nathanson (24), Stonich (71), and Prasad (53). Other authors, although not including reward systems in their models, discuss the reward system and its importance to success in reaching corporate objectives (4, 8, 46, 51, 72, 73).

The underlying premise for the inclusion of the reward or incentives system either in the model or in a discussion of a model is the potential motivating power of monetary rewards. Gellerman (25) summed up this idea by stating that the reward system is always motivating people to do something, and sometimes the reward system is motivating people to do things which are not consistent with the achievement of corporate objectives.

While motivation theory is undeniably important, neither strategists nor practitioners identify or discuss one particular motivation theory. In the literature, there seems to be a pervasive underlying assumption that some motivation theory is at work, and which theory it is is not particularly important. The approach taken by strategists is to assume money can motivate.

Executive compensation studies can be grouped into three basic types. The first group explores the issue of whether or not companies do pay for performance. The

literature yielded no definite answer yet approximately one-half of the studies indicated that companies do pay for performance.

The second group explores the question of whether or not pay can motivate people to perform better at the executive or managerial level. Again, no definite answer was to be found in the literature.

The third group examined strategic compensation, which had only two studies. Both of these studies indicated that strategic compensation has value -- one study showed better financial performance and one study showed improved performance of middle management.

Taking these studies in aggregate, one conclusion can be safely drawn; there are many variables which enter into the evaluation of the results of these studies that seriously impair their interpretation. Regardless of these research difficulties, companies are attempting to evaluate their compensation systems to better their financial performance and to justify their executive compensation plans. Identifying and monitoring internal and external factors affecting their compensation systems are helping them do that.

In order to approach the development and operation of a strategic compensation plan in a systematic manner, a model of such a process has been developed and discussed.

CHAPTER 3

METHODOLOGY

The methodology of this study is described in this chapter. Because of the lack of previous research concerning the link between strategic management and strategic compensation, the exploratory case study method was utilized.

This chapter contains the definitions used in the study, research questions and propositions, a description of the sample of cases, the case research design, data gathering, data analysis, and a summary.

Definitions Used in the Study

There are two classes of definitions utilized. While the first class contains the terminology used in the research questions and propositions, the second class contains various possible components of executive compensation. Firms were expected to have several of these components, but not all of them.

The second class of definitions is found in Appendix A. The first class of definitions follows in the next section.

Strategic Management (SM) is concerned with the long-range goals of an organization and with the course or courses of action to achieve them, considering environmental conditions, available resources, and degrees of risk (30, p. 7).

While a preponderance of definitions are available in the literature for the term strategic management, Wortman's (30) definition best embodies the underlying concepts of its meaning. Moreover, this definition specifically mentions key elements involved in the idea of strategic compensation.

Being concerned with the achievement of long-term goals is not enough, achievement of these goals must be through the strategies chosen and agreed upon by key executives. Implied also is that the strategy chosen is consistent with the overall manner in which business is normally conducted by a particular organization.

The last phrase of the definition indicates that both an external and internal analysis is conducted and incorporated into the decision concerning objectives establishment and strategy development. Furthermore, the risks of the strategy chosen are estimated before the strategy is operationalized.

Strategic Compensation Planning (SCP) (42) is the deliberate design, communication, and administration of the executive compensation system in such a way that it facilitates the achievement of both short-term and long-term corporate goals, through and consistent with the chosen strategy.

Although compensation planning is not new (42), compensation planning that is strategic in nature has some distinct differences from compensation planning that is not.

The achievement of both short-term and long-term goals means that both are important. In other words, long-term goals and the achievement of those goals are as important as the achievement of short-term goals.

Stonich (72) indicated that a problem exists in companies claiming to use a compensation system with long-term incentives. Companies tended to see the long-term component as less important than the short-term component as evidenced by the weighting of the value of long-term and short-term accomplishments.

In addition, how goals are achieved is important in strategic compensation. A division head who cuts back personnel, refuses to buy equipment needed to keep a competitive edge, and de-emphasizes new product development in order to achieve a goal would not be eligible for a performance-based bonus if his/her actions described above were contrary to the chosen strategy.

Communication is essential to strategic compensation as participants involved know how the system operates. By understanding the system in general, and knowing how they themselves will be evaluated specifically, the organization is making clear what is important (42).

Finally, strategic compensation is deliberate. Since designing such a system is difficult, many companies have opted to tack on long-term rewards to their present compensation plans. Such a plan is not strategic. Strategic compensation involves a premeditated attempt by the organization to ensure both short-term and long-term success through a plan subsumed under strategic management.

Corporate Objectives are statements of the results a business seeks to achieve through its activities over a specified period of time (50, p. 184).

In order to be consistent with the definition of strategic management used in this study, recognition of the existence of short-term, mid-range, and long-term objectives is necessary.

Specifically, strategic management and strategic compensation planning emphasize the long-term (usually considered five years) because short-term is subsumed under long-term and because long-term has traditionally been underemphasized and minimized in importance.

The theoretically ideal situation is for corporations to set long-term objectives and use short-term objective achievement as a measurement of progress. Short-term objectives should be subsumed under and consistent with long-term objectives.

Executive Performance Objectives are statements of what (and sometimes how) an executive is expected to achieve within a given time period.

While the definition given of an executive performance objective is straightforward, there are considerations necessary to the understanding of the definition. These objectives must provide executives with a "clear understanding of what is to be achieved" (50, p. 188). Ambiguity in objectives is to be avoided at all cost because misunderstanding may cause executives to move towards goals incompatible with corporate objectives.

Richards summed up the importance of clear, communicated objectives when he stated, "Carefully considered objectives help avoid misdirection, vacillation, and mere drifting" (63, p. 1).

Eligible Top Executives is that portion of the group of upper level managers or executives who, by definition of the firm involved, are participants in the executive compensation plan.

Normally, a company involves only the very uppermost executives in any compensation plan which utilizes long-term incentives. Fox called this a "limited group of top executives" (20). In most executive compensation plans, the number of executives eligible for the full gamut of performance-based pay is small. Individual companies define that group of executives by themselves. Fox also noted that only top executives could logically be expected

to make a large impact on corporate performance, especially over a three to five year time span (19).

Internal Variables are factors over which the firm has some measure of control.

These are factors relating to each individual firm over which the firm has some measure of control. Sometimes these internal factors are enumerated in great detail in internal audits or internal assessments, indicating that firms have many basic common factors which they are capable of manipulating. What specific variables a firm recognizes and chooses to deal with is firm-specific. Overall, in the field of strategic management, the factor which separates internal from external factors is the element of control.

External Variables are those factors over which the firm may have varying degrees of influence, but which are largely beyond the control of the firm.

This definition, again, is one that is generally accepted in strategic management. Many authors (3, 30, 42, 71) break the external environment into two general areas. The first area impacts the firm directly while the second area impacts the firm to a lesser degree. While different authors have different names for these two segments, Pearce and Robinson referred to them as the remote environment and the task environment, respectively (50).

Within the remote environment, also called the general environment, there are economic, political, social, and technological variables (50, p. 103). The task environment has competitors, creditors, customers, labor markets, and suppliers as variables (50, p. 103).

Firms must contend with changes in these variables because, to varying degrees, they can influence but not control these variables.

Points of Information Exchange are direct, observable links between the strategic management process and the strategic compensation system.

In order to establish how and where the strategic management process and strategic compensation process are linked, some mechanism of information exchange must exist. Since these points are being postulated, it is difficult to propose what they might actually be. Variables in this area have not yet been defined.

These definitions will be utilized in the research questions and propositions presented and discussed in the next section.

Research Questions and Propositions

The research questions and resulting propositions are intended to further the understanding of the process of strategic compensation and its relationship to the strategic management process in an organization. The answers to the research questions are intended to provide

a core of knowledge from which testable hypotheses can be generated for future research. Due to the exploratory nature of this investigation, the primary emphasis is examining current attempts by organizations to make strategic compensation viable.

Research Question I: What internal variables and external variables are identified and considered in the design and administration of strategic compensation systems for the eligible group of top executives, and how does the system identify and accommodate changes in these factors?

The major point of the first research question is to identify the important considerations in designing the framework for the compensation system. Firms using strategic compensation have had to contend with many similar external pressures such as: inflation (42, 48, 77), changing tax laws (33, 42, 58), the proliferation of available information on what the competition in the same industry pays (26, 35, 42, 48, 79), and the emergence of the executive recruiter (48, 79). Each of these tends to disrupt the equilibrium of the current system and encourage shifts in different elements of the system to accommodate changes in these factors.

Several authors have suggested that firms should make their compensation systems unique (to their firm), and that minor changes in external variables should not result in automatic changes in the compensation system (11, 42,

65). The key appears to be recognizing what factors will influence the system for that firm, and incorporating possible changes into the design. This is similar to the way that corporate strategies are chosen after the recognition of major changes in factors which will influence the effectiveness of the strategy over the next three to five years.

Overall, the first research question addresses the relationship between the environmental analysis in the SMP and the utilization of this information in the SCP as depicted in the theoretical model (see Figure 2.7 on page 70). Specifically, the internal variables are proposed to provide the framework upon which the compensation plan is built. The external analysis is completed in the SMP, and information concerning relevant variables is channeled into the SCP. Not all variables in the external environment have a direct bearing in the SCP, but information concerning those variables of importance to the SCP is transmitted.

As seen in Figure 2.7 on page 70, the formulation of the executive compensation reward system takes place after both internal and external variables have been identified and monitored. Moreover, the establishment of corporate objectives occurs after internal and external analysis occurs in the SMP. Corporate objectives are set after a determination has been made concerning what the

organization is capable of doing considering both internal and external factors. Major unexpected changes in either internal or external factors may force an organization to modify its corporate objectives. The model allows for this information to be fed back into the formulation stage of the SCP.

Proposition I.1: The major external variables which will be considered by firms are industry, compensation systems of competitors in the same industry, economic conditions, particularly inflation, and tax laws.

It is proposed that companies utilizing strategic compensation systems will identify external factors which affect their systems, and will forecast changes in these factors for a period of more than one year. The forecasts will then be used in establishing the framework of the system. The system, theoretically, will be designed to accommodate minor fluctuations in recognized variables. A major change in variables will result in modification to both corporate objectives and executive performance objectives.

The external analysis conducted in the SMP, as depicted in Figure 2.7 on page 70, is the complete monitoring of external variables of importance to the organization. Because not all of these variables are important to the formulation of the executive compensation system, information transmitted to those who design and

administer the system pertains to variables determined to be relevant.

The literature serves to support the industry (21, 38, 38) compensation systems of competitors (48), economic conditions (42, 48, 77), and tax law changes (42) as the major external variables which affect design of executive compensation systems. Information concerning these variables is determined to be relevant information.

Proposition I.2: The major internal variables which will be considered by firms are size of the firm, strategy and resulting structure, culture, and financial constraints.

The internal variables operating to influence the executive compensation system are: the size of the firm (18, 23, 38, 54), the strategy used and the resulting structure (32, 45, 48), culture (10, 71, 76); and financial constraints. The combination of these unique internal variables will constitute a result peculiar to each individual firm. Therefore, more variation in response is suspected in this area.

With regard to the proposed model (see Figure 2.7 on page 70), internal variables are identified and evaluated during the SMP. While not all internal variables have a direct bearing on the formulation of the executive reward system, the important relevant variables are of great importance in establishing the parameters of that system. These variables operate as constraints (or boundaries) in

the design and administration of the executive compensation system.

The theoretical model shows that internal analysis is conducted prior to the determination of relevant information from the external analysis. This is done purposely to indicate that even objective information gathered during that external environmental analysis will be colored by or interpreted in the light of the internal situation of the organization.

Proposition I.3: Forecasting anticipates changes in the external variables which affect the executive compensation system.

In keeping with the idea that strategic compensation should be anticipatory, it is proposed that some type of external monitoring of pertinent variables will occur. The purpose of the monitoring could be either to await significant outcomes (of major legislation, for example) or to watch for significant changes in the variables. While minor changes are to be observed and tolerated by the system, major changes will cause modification of corporate objectives and executive performance objectives. In this way, the system can identify changes which occur in these external variables.

Forecasting is consistent with the definition of strategic management used in this study. That is, "being concerned with the long-range goals...considering environmental conditions, available resources" (30, p. 7).

While not specifically shown in the proposed theoretical model, the use of forecasting in an external environmental analysis, as in most strategic management models, is implicit.

Proposition I.4: Major changes in these internal and external variables are used to modify corporate performance objectives and executive performance objectives.

While strategic plans are usually structured to accommodate some change in important variables, major changes usually cause corporations to modify their projections. If corporate objectives are modified, then executive performance objectives should be modified as well. This would be the method by which the system could accommodate changes in these factors.

While such major changes are unusual, strategic compensation requires, minimally, some recognition of such possibilities. Ideally, both positive and negative major changes are considered.

In Figure 2.7 on page 70, major changes in variables are accommodated through the feedback mechanism. When major changes occur in either internal or external variables, this should trigger the reformulation of more realistic corporate objectives. This information, in theory, should likewise result in a modification to either executive performance objectives or the design of the executive compensation system or both.

In conclusion, what strategic compensation planners consider important in the design of their executive compensation systems may assist other firms in deciding what factors to consider in the design and operation of their strategic compensation systems. Once the variables have been identified, then the system can be designed and operationalized.

Research Question II: How does the strategic compensation system operate and what is its design?

Since this is an exploratory study, the issue of how the strategic compensation system is designed and operated must be addressed. What is thought to make the strategic compensation different from other compensation systems is the conscious and deliberate attempt to use the motivational aspects of compensation to facilitate the achievement of corporate objectives through the chosen strategy.

A key idea is to discourage achieving corporate goals through means which may be detrimental to the firm either in the short-term or the long-term. The idea is not new -- the early policy writers discussed the importance of integration of all systems to facilitate achievement of corporate objectives. In 1971, Andrews provided a full discussion on the importance of rewarding top executives for their contributions made in achieving both short-term and long-term goals through agreed upon strategy, and not

by avoiding necessary major capital expenditures or pruning research and development budgets (3). He clearly stated the need to measure progress towards the goals for the purpose of evaluating strategy and executive performance through the control phase of the planning process (3, pp. 178-238). The idea is not hidden or obscure; it is inherent even in the definition of strategic management used in this study, "being concerned with long-range goals of an organization and with the courses of action to achieve them" (30, p. 7).

McLaughlin believed that it is more in line with strategic thinking to derive a reward system which encourages executives to act in a manner which supports the achievement of strategy (42). The research question tries to find out how the firms in the study are operationalizing the alignment of the traditionally distinct systems of compensation and strategic management.

This research question attempts to test the model of the relationship between the strategic management process and the strategic compensation process which was proposed in Figure 2.7 on page 70. By looking at three operational strategic compensation systems, a comparison of the proposed model and a model resulting from the cross-case analysis can be made.

Proposition II.1: Designers of the executive compensation system where strategic compensation planning is employed are knowledgeable about what the corporative objectives are and what the chosen strategy is to meet those objectives.

This proposition reflects the idea that designers of the executive compensation system must have knowledge of corporate objectives and the agreed-upon method (strategy) for reaching these objectives in order to be able to construct a system which rewards short, interim, and long-term individual executive goals.

What is strongly implied is that the means for attaining goals has great importance. Strategic compensation should attempt to reward top executives for the achievement of corporate objectives through the chosen strategy. In this way, executives are discouraged from utilizing strategies which may have injurious long-term effects on the well-being of the firm.

Although reward systems have traditionally been developed outside of strategic management considerations (42), the formulation of the strategic compensation system is done by informed designers. In the theoretical model, the formulation, implementation, and control in the SCP are carried out with corporation objectives and the chosen strategy is the basis for the system. Designers are knowledgeable about the strategic management of the firm.

Proposition II.2: There are several identifiable points of information exchange between the strategic management process and the strategic compensation process.

Although each firm practicing strategic compensation has its own process, there is a postulated information exchange between the two systems in all phases of the strategic management process--formulation, implementation, and evaluation. Identifying these points of information exchange helps to determine the design of each system. The proposed model does not endeavor to define exactly what the nature of the exchange is, but does attempt to show the proposed exchanges between the two processes.

Proposition II.3: Executives are made aware of: (a) corporate objectives and (b) their performance objectives, and they know how they are to be evaluated with regard to their compensation.

In order for executives to comply with the spirit of strategic compensation planning, they must know how they will be evaluated. McLaughlin stated that he believes reward systems are always rewarding people for doing something (42). By making executives aware of what results will be worthy of reward, people will be rewarded for doing that which contributes to the achievement of organizational objectives. The clearer the relationship between actions and rewards, the easier it becomes to identify appropriate behaviors. In strategic

compensation, making this relationship clear is built into the design of the system.

With regard to the proposed model, the establishment of executive performance objectives occurs during the formulation process. Evaluation of performance is closely tied to the evaluation of corporate performance because executive performance objectives should be a subset of overall corporate objectives.

Proposition II.4: Designers and administrators of the strategic compensation system have a formal mechanism to evaluate problems and potential improvements in the system.

Since most strategic compensation systems are of recent vintage, revisions to make the systems better are expected. In as much as planning systems have been revised and improved over the years, strategic compensation systems will most likely endure a similar evolution.

The newness of these systems will require some mechanism to report problems and suggest improvements. The model accommodates this mechanism in the feedback loop. Without a provision for evaluation and improvement, strategic compensation systems would most likely be discontinued for easier approaches to compensation.

The operation of strategic compensation systems is relatively new, and therefore the experience effect will often cause refinements and sometimes cause overhauls of

the system to take place. These overhauls will probably either come from the executive Vice President of Human Resources or from the compensation committee of the Board of Directors. It is believed that a firm astute enough to try strategic compensation will also recognize the need for adjustments.

In summary, the exploratory nature of this investigation dictates that the research questions address fundamental issues. Therefore, each firm's system is described in terms of variables considered and how the system is designed and administered.

Sample of Cases

Because of the limited number of firms currently using strategic compensation, generating a random sample was not plausible. Initially, potential companies had to be located through referral by individuals with some knowledge of the firm's management and compensation practices. A total of three firms are included in the sample.

Once a referral was made, information concerning the firm was sought through secondary sources. Annual reports, 10-K's, business periodical articles and newspaper accounts were the sources used to establish background information.

The criteria for inclusion in the study were:

(a) firm practices strategic management;

(b) firm practices strategic compensation;

(c) firm was willing to divulge adequate information to complete study (necessary due to the sensitive nature of the topic); and

(d) firm was located in New England.

During the course of the location process, sixteen firms showed some possibility of being a candidate for the study. Several firms superficially fit the criteria of using both strategic management and strategic compensation criteria. Most were dropped because of the compensation requirement. Others were excluded because they were not inclined to discuss executive compensation at all.

Even when a firm met these requirements and expressed a tentative willingness to discuss their compensation practices, problems occasionally ensued. For example, one firm had just merged and could not make known the information in either the 10-K or the annual report for legal reasons. In another firm, the initial contact thought the firm was using strategic compensation, but on further investigation found the firm was not using it.

Case Research

Because of the difficulty in controlling the events under investigation, the case study was chosen as the

appropriate methodology. "How" and "why" questions can be answered by experiments in a laboratory setting, but the variables operating here have not as yet been established. Attempting to manipulate variables which are as yet unidentified would be inappropriate.

The design for this study is the multiple case, holistic design (81, p. 4). Under consideration are three firms, each utilizing strategic management and practicing strategic compensation for an identifiable, eligible group of executives. The fact that three separate entities are being scrutinized makes this a multiple case design. Because one unit (rather than several individual subunits within each firm) is being looked at, the study is defined as "holistic" as opposed to "embedded".

While the multiple case design utilizes more than one unit of analysis (or subject), a case study is conducted separately on each individual unit. Only when all data have been summarized for each individual firm can the study proceed to the next stage, that of doing cross-case analysis (81, pp. 27-35). Since this is an exploratory study, causality is not implied in any results. Cross-case analysis attempts to answer the research questions and address the propositions which are derived from them. At this point, the last two purposes of the study were fulfilled: providing practitioners with information which may have immediate application in their organizations and

determining if strategic compensation planning may become another consideration in the strategic management of firms. The research design model to be employed in this study is illustrated in Figure 3.1.

In order to execute a case study successfully, it is necessary to consider the most serious possible methodological problems. Objections to the use of the case study methodology have centered on (a) the inability to obtain unprejudiced, objective observations (37, p. 321); (b) the difficulty in replication (37, p. 320 and 81, pp. 34-42); and (c) the generalizability of the study (37, p. 320 and 81, pp. 34-42). How each of these legitimate concerns was addressed in this research is discussed in the following paragraphs.

Construct validity in case studies is the first concern mentioned above. Construct validity requires researchers to operationalize measures properly for the concepts under study (81, p. 36). Two steps must be accomplished to meet the test of construct validity. First the researcher must select specifically what is to be studied, and second, the researcher must show that the chosen measure reflects that which is being studied (81, p. 37) To strengthen the construct validity, it is also possible to use more than one source of evidence during data collection (81, pp. 36-54, 78-98). This technique will be employed in this study. For example,

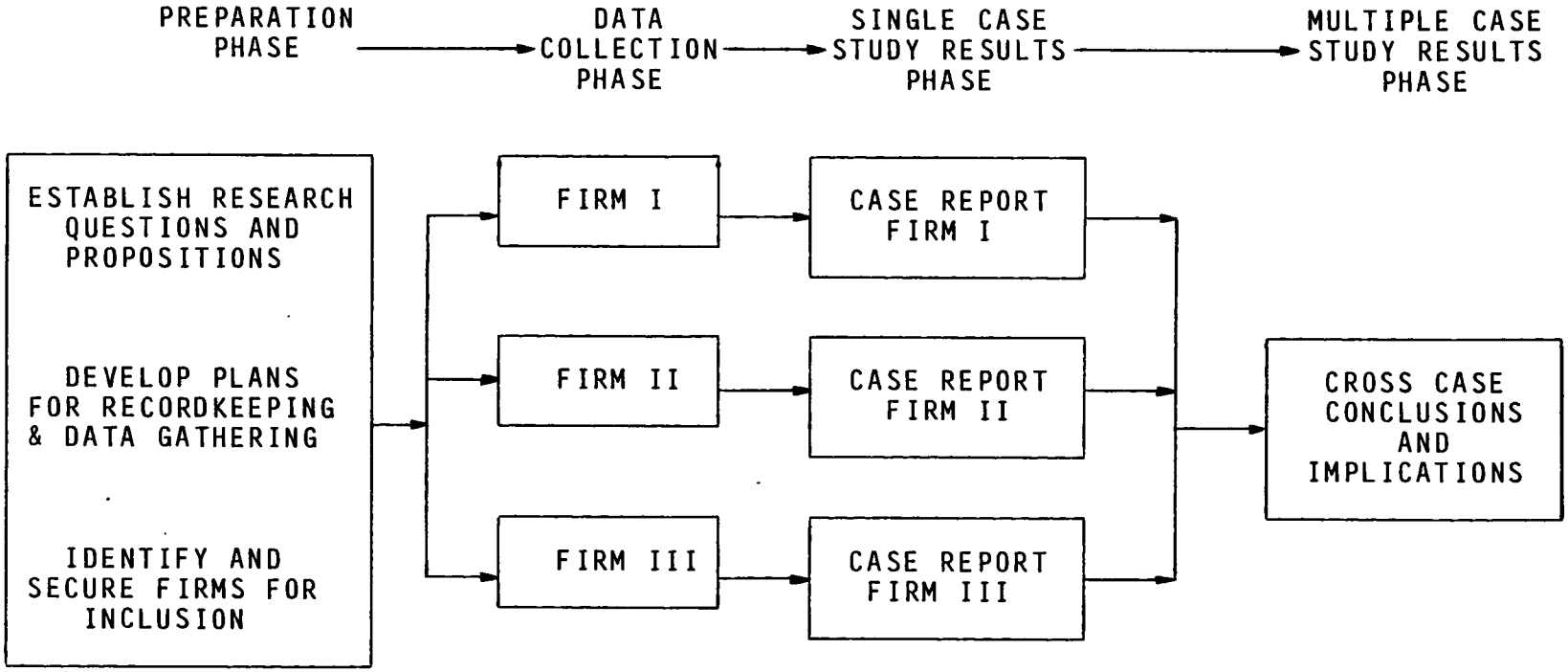


Figure 3.1. The Research Design.

SOURCE: Adapted from Robert K. Yin, Case Study Research Design and Methods, Applied Social Research Methods Series. Volume 5. Beverly Hills: Sage Publications, 1984, p. 51.

the two primary criteria for a firm's inclusion in the study were: (a) strategic management was utilized in the firm; and (b) strategic compensation planning was concurrently utilized in the firm. Multiple sources of evidence generated within and without the firm, both written and verbal, established that the firm met the criteria for inclusion. A sample documentation form supporting a firm's use of strategic management is shown in Figure 3.2.

Reliability is established when a study can be repeated by another researcher with the same results. A complicating factor which applies to the case study, and other types of studies as well, is the passage of time. However, reliability can be provided for in the careful design and execution of the data collection procedures. This is accomplished through meticulous documentation and recordkeeping coupled with explicit written plans as to how the study will proceed. Obviously, for any multiple case design where cross-case results are pooled, completion of the study would be impossible without a formal plan and recording of data (81, pp. 35-40, 64-146). This study utilized a documentation and recordkeeping plan to provide this study with reliability and to provide future researchers with a workable plan upon which additions and improvements may be made.

Documentation Worksheet

Firm Number _____

Issue: Verification of Use of Strategic Management

Part I: Written sources of evidence and a brief description

Annual report

10-K

Proxy statement

Popular press

Internal documents

Other

Part II: Verbal sources of evidence and a brief description

Within firm

Outside firm.

Figure 3.2. Documentation Form Used to Establish Multiple Sources of Evidence.

Lack of generalizability to other cases is a long standing criticism of case studies. Yin (81) pointed out that critics fail to realize that only survey research is readily generalizable to a larger universe and the case study does not purport to be generalizable to a larger universe. Case studies rely on analytical generalization, where the researcher attempts to generalize results to a broader theory. Single case studies may contribute to theory, but generalization comes only with other case studies examining the same phenomenon. Multiple case studies, such as this one, utilize the idea of replication to increase generalizability to theory (81, pp. 35-40). To do this, the researcher must build a chain of evidence using material from each of the single case studies. Answers to research questions must be developed in this manner during the cross-case analysis (81, pp. 63-64).

Internal validity is also a frequently mentioned criticism of case studies, but it deals primarily with the establishment of cause in a relationship between variables. Exploratory case studies are not concerned with establishing causality; therefore, this study does not attempt to establish internal validity (81, p. 36)

This section has discussed the methodology utilized in this study, and the way in which reliability, generalizability, and construct validity were handled in

the design of the study. Causality is not implied in an exploratory study such as this.

Data Gathering

Since no random sample was used, data gathering consisted of two parts. The first part was concerned with identifying possible organizational candidates and establishing their final status. The second part was concerned with gathering information about the company's strategic compensation plan.

Qualifying Candidates for the Study.

In order to qualify for inclusion in the study, organizations had to meet the four criteria previously established. Attempts to locate firms meeting these criteria included scanning recent articles about compensation practices, and utilizing the personal knowledge of professionals in academics and business who live and/or work around Providence, Rhode Island.

Leads were pursued through an examination of the Annual Report and the 10-K report. Next the Business Periodicals Index, Business Index, and Rhode Island Index were consulted for additional information about the company's management and incentives system practices.

Then a call was made to an individual in the firm in either a strategic planning or compensation capacity as a preliminary attempt to see: (a) if the firm still

remained a candidate; and (b) if the firm might be willing to participate. Usually these individuals had to discuss possible inclusion in the study with one or more other persons due to the sensitive nature of topic. The decision made by the key individuals within the firm determined whether or not any particular firm could still be considered a candidate for inclusion in the study.

Gathering Information About the Company's Strategic Management and Compensation Practices.

The interview was planned to be the primary source of data in this segment of the study. At a minimum, two lengthy interviews were to be held with both the compensation executive and an executive who had intimate knowledge of the strategic management process. The questions used in these interviews were open-ended. These questions are meant to be utilized for interviewees in different positions; therefore, not all questions are appropriate for each interviewee. Additionally, some questions will be answered from secondary data sources such as newspaper clippings, annual reports and profit statements. Such tactics lend support to (or detract from) the information supplied during an interview. The list of open-ended questions is located in Appendix B.

The interviews were informal and not highly structured to encourage subjects to discuss the topic freely. Interpreting their personal observations,

feelings, and evaluations about the strategic management and/or compensation process(es) was important in the attempt to establish how the process worked in reality.

Written explanations, diagrams, tables, and other supplemental data were not required of the interviewee but any materials offered would be utilized to strengthen construct validity of that particular case. A verbal description of the strategic management and strategic compensation processes was expected.

Interviews lasted approximately one hour. Permission to contact subjects for additional information either by phone or through another interview was requested.

Data Analysis

Since this case has as the research design the cross-case analysis, each organizational (case) study must be completed individually and separately first. The data gathered for each case consisted primarily of information gathered in the interview process, information gathered during the qualifying process, and other supporting evidence.

The case study chosen for this analysis was the exploratory case study. The research questions being asked in this study are "what" and "how" questions concerning a topic about which little is known (81, pp. 15-19). Survey research was not an obvious consideration

for this study because determining the use of a strategic compensation system in a firm was not easily accomplished. In fact, the choice of the case study as the appropriate research method is reinforced in this statement by Yin concerning when the case study is appropriate, "a 'how' or 'why' question is being asked about a contemporary set of events over which the investigator has little or not control" (81, p. 20).

The data gathered focused on the two research questions and the resulting propositions. The answers to the research questions concentrated on the first two purposes of the study, namely to investigate the operations of viable strategic compensation systems in three firms and to try to identify major variables operating in these systems. The cross-case analysis endeavored to determine if strategic compensation may be a viable consideration in the future strategic management of firms and to provide practitioners with a viable model for strategic compensation based on the models of the three firms.

Each of the two broad research questions and the o r e specific, resulting propositions served as a central focus in data analysis. For each firm, the questions were addressed and answered. After each individual case was completed, a cross case analysis was conducted. For each

proposition, and each research question, similarities and differences were indentified and discussed.

Research Question I, which concentrates on identifying variables and anticipating changes in these variables can also be compared to variables which were identified in the literature. Research Question II focuses on the design and operation of the strategic compensation system in each firm. Comparison of these systems with each other and with the model proposed in Figure 2.7 on page 70 should offer some insight into how such systems operate. Identification of problems and strengths in each system could lead to concrete suggestions for the construction of an improved model design.

Summary and Conclusions

While many studies only have one set of definitions, two sets are required for this case study. The first set of definitions is utilized in the research questions and propositions asked in the study. The second set of definitions stands ready to be utilized in the responses expected from the research questions.

Two basic questions were asked in this exploratory case study. First, what are the variables involved in strategic compensation and how are changes in the variables identified and accommodated? This is a "what"

and "how" question that seeks to explore how a phenomenon operates.

Internal and external variables which affect executive compensation were identified in the literature. This case study offers a basis for comparison to the literature. Additionally, forecasting is done to anticipate changes and, for major unexpected changes, corporate objectives are modified.

Second, the study sought to learn the design of the strategic compensation system and how it operates. It was proposed that: designers of the system know about corporate objectives and strategy, there are identifiable points of information exchange, executives being evaluated by the system know what the evaluation plan is, and some mechanism exists to improve the system.

Firms included in the study were picked carefully so the case could answer the research questions. Because executive compensation is a sensitive topic, many possible candidates for inclusion declined. Since strategic compensation is rare, finding possible candidates was difficult.

The research strategy chosen was the exploratory case study and the research design was the multiple, holistic case design. Methods of gathering data are the interview and documentary evidence.

Interpretation of results came from applying the data to the propositions and research questions, first on a case-by-case basis and then cumulatively for the cross-case analysis.

Methodological problems of case studies were addressed, namely: construct validity, reliability, generalizability, and causality.

In conclusion, an exploratory study of the relationship between strategic management and strategic compensation was accomplished through the use of a holistic, multiple case research design. The study concentrated on providing a realistic prototype for strategic compensation systems by examining such systems in the firms currently using them. While causality was not implied in the study, problems with and strengths of these systems were identified.

CHAPTER 4

A NOTE ON THE BANKING INDUSTRY

This chapter contains a brief industry note covering the area in which the three organizations analyzed are operating. That industry is banking, but the following discussion illustrates how much that generic term has changed in meaning. This note provides insights into the forces driving the industry and how these forces affect the comments, thoughts, and decisions of executives presented in the case analysis.

While "the banking business" has long been accepted as the phrase to describe a certain class of activities limited to certain federal- and state-chartered and controlled institutions, this phrase, "the banking business", has become outdated. Instead, the phrase "financial services industry" has become a better descriptor of how this industry currently operates.

Since money has a great impact on our national economy, banks and their activities have been of concern to the federal government from the time of the founding of this country. Although some changes have occurred over the two hundred year history of this industry, the numerous changes over the last ten years have been profound. A terse summary of the cause of that change is one word--deregulation.

Because of the Depository Institutions Deregulation and Monetary Control Act of 1980 (DIDMCA), the nature of competition in the industry has been radically altered. To complicate matters further, financial services companies of many varieties have appeared. These companies have been dubbed near-banks. The issues of deregulation and changing competition, coupled with other external environment and industry factors, have led to the creation of a volatile, turbulent environment in a very short period of time. The following sections discuss the changes in the environment in which banks must now do business.

Political/Legal Forces in the Banking Industry

Like many other industries, the law and regulatory framework in banking have been developed in direct response to problems and changes which have occurred. The premier law in banking which governed the industry for many decades was the Banking Act of 1933, commonly referred to as the Glass-Steagall Act (64, 67).

The Glass-Steagall Act prohibited the underwriting and selling of stocks by domestic banks (16, p. 135). Additionally, the law set interest rate ceilings on savings accounts (Regulation Q), forbade the payment of interest on demand deposits (checking accounts), and

introduced a temporary plan for federally insuring deposits (64, p. 32).

Two years later, the Banking Act of 1935 was passed. Because that economic era (the Depression) had caused a severe lack of confidence in the banking system, Congress was still seeking to provide a means to increase stability and trust. Overall, this act enlarged the powers of government control over the industry by strengthening the authority of the Federal Reserve Board. Concurrently the Act made the Federal Deposit Insurance Corporation (FDIC) permanent and put all insured banks not under the supervision of a federal agency under the FDIC's supervision (64, pp. 32-33; 7, pp. 81-90).

Taken together, these two acts constituted the last major structural overhaul of the financial industry until DIDMCA was passed in 1980. The purposes of the overhaul in the Depression Era were: (a) to help ensure the safety and stability of the financial institutions; (b) and to assure different sectors in the economy had adequate funding (5, p. 94). The former was intended to curb the frequency of bank failures by applying legislation and regulation to provide more uniform policing of financial institutions. The government had learned that individual bank failures can be quickly translated into distrust of the banking system as a whole (7, p. 75). The latter was accomplished by recognizing different kinds of

institutions for the major economic sectors. Commercial banks handled commercial enterprise, savings and loans granted home mortgages, and credit unions and finance companies provided consumer credit (5, p. 94).

When DIDMCA was passed in 1980, the most recent effort at restructuring the industry occurred. Like the reforms of 1933 and 1935, DIDMCA came about as a result of changing conditions in the economy--mainly "high interest rates, tight money conditions, and disintermediation" (64, p. 65). What this law did was to phase out the ceiling on interest rates that banks and savings and loans could pay savers (Regulation Q) and mandate that all depository institutions meet reserve requirements (47, p. 5). Additionally, DIDMCA now authorizes the charging of fees for services performed by the Federal Reserve Bank. Prior to the passage of the law, member banks did not pay these processing fees.

Speculation on the future by bank experts supports the contention that more banking laws are forthcoming (14). Specifically, legislation is probably forthcoming on the following issues: the definition of a bank (14), foreign banks (15), allowing commercial banks to underwrite securities (15, 16), nonbank banks (55), and interstate banking (55, 67). While many of these issues are strongly related to the political/legal segment of the external

environment, they are discussed in the following section on competition.

Changing Competition in Financial Services.

One major effect of the Banking Act of 1935 was the creation of a distinction between commercial banks, savings and loans, and credit unions and finance companies (5, p. 94). This distinction was based on what each of these types of institutions was allowed to offer to its customers. By definition, the distinction also delineated the competition quite clearly.

Since the 1930s, these competitors and a few new ones, have made these distinctions less clear. In other words, either by legislation and regulation or lack of it, competition has become intense among financial institutions.

Foreign Banks.

While foreign banks do not operate with equal intensity in every region of the United States, the presence of foreign banks has become much stronger in recent years. For example, of all loans currently made to U.S. businesses, 20 percent were made by foreign banks and that was twice the number made just eight years ago (15, p. 94). The 600 foreign bank offices open in the U.S. in 1987 represent a 300 percent increase over the number ten years previous (15, p. 94).

Foreign banks were able to engage in interstate banking (which was forbidden to domestic banks by the McFadden Act of 1927) (64, p. 85). Until 1978, foreign banks were allowed to underwrite securities and sell stocks. Although the International Banking Act of 1978 limited this practice, fifteen big banks were grandfathered and allowed to continue (15, p. 94. See also 64, p. 85).

Although DIDMCA now requires that foreign banks comply with Federal Reserve requirements, the previously loose restrictions for foreign banks allowed them to gain a competitive advantage over domestic banks. Senator Proxmire, Chairman of the Senate Banking Committee, expressed concern about "the growing presence of foreign banks in this country" (55, p. 30).

Nonbank Banks.

Whatever is not a bank by definition is a nonbank by default. Nonbanks enjoy a huge competitive advantage over banks because they are exempt from bank regulation. Because nonbanks slip through what Senators Proxmire and Garn have called the nonbank loophole, both Senators want nonbanks eliminated, and prefer to have no grandfathering of existing institutions (47, p. 5).

At one time, each type of bank had its own market delineated by function. Looking at Table 4.1, the functional distinction has been all but eliminated. Some

Table 4.1. The Functional Distinctions between Banks and Other Financial Institutions Have Become Blurred as Can Be Seen By Differences in Products Offered By These Institutions Between 1960 and 1982.[a]

Product	Type of Financial Institution				
	Banks	S&Ls	Insurance Companies	Retailers	Securities Dealers
Checking	* o	o	o	o	o
Saving	* o	* o	o	o	o
Time Deposits	* o	* o	o	o	o
Installment Loans	* o	o	o	o	o
Business Loans	* o	o	o	o	o
Mortgage Loans	o	* o	o	o	o
Credit Cards	o	o	o	* o	o
Insurance			* o	o	o
Stocks, Bonds			o	o	* o
Mutual Funds			o	o	* o
Real Estate			o	o	o
Interstate facilities			o	o	o

Key: * 1960
o 1982

[a]Adapted from: Koch, Donald L., and Steinhauser, Delores W., "Challenges for Retail Banking in the 80's," Economic Review, (May 1982):14.

types of nonbank banks are mutual funds, money-market funds, insurance companies, pension funds, finance companies, large manufacturing companies and retailers (64, p. 74-75).

To illustrate some competitive advantages of nonbanks, auto manufacturers can make loans to people in all states, but banks are subject to branching and interstate banking laws. Sears offers credit in its nationwide chain, and because Sears is free to acquire companies in financial services, the potential exists to offer banking at each of its stores (64, p. 75). Banks are subject to laws governing banking holding companies and interstate banking laws. Additionally, nonbanks can offer virtually any product to consumers. Although banks can do such things as sell insurance, they are required to adhere to strict regulations and even regulated competitive advantages (60).

What nonbanks do is to "separate lending and deposit functions" by putting each into a separate subsidiary (64, p. 76). A commercial bank is legislatively defined as any organization that offers both demand deposits and commercial loans (64, p. 76). As long as a company separates what the subsidiaries do, no one legal entity meets the legal definition of a bank, and thereby avoids banking laws and regulations.

To illustrate how strong these nonbanks are, Merrill Lynch has money managed assets of $41 billion and Sears, excluding real estate and securities subsidiaries, would be the twentieth largest bank in the United States (64, p. 76).

For this reason, deregulation of the industry is now being tempered with a move towards eliminating the nonbanks. They are engaging in financial activities which are meant to be regulated, and by doing so, gain access to the benefits of engaging in the industry without bearing the costs of being regulated.

Interstate Banking.

The last major area concerned with competition is interstate banking. Although interstate banking has a great supposed impact on competition, there are other important issues which are contingent upon how much further the states allow over-the-border banking to occur. These issues are discussed at the conclusion to this section.

The history of banking explains why interstate banking is not as prevalent as it might be. Following the failure to recharter the Bank of the United States in 1836, the individual states controlled commercial banking. Therefore, states chartered banks in their respective states and did not provide for a way for banks chartered

in other states to enter. Thus banking became a local industry (67, p. 79).

Concurrently, the national banking system did not extend a way for a bank to move out of its home state. In fact, the National Banking Act of 1863 was interpreted to mean that a national bank was forbidden to have branches even in its own state--a major disadvantage because some states allowed the state-chartered banks to branch in the states (67, p. 79). As a result, this competitive disadvantage caused many banks to switch from being a national to a state bank, a potentially dangerous situation in light of the fact that state banks had less stringent regulations. In an effort to reduce the number of such conversions, federal laws (McFadden Act of 1927 and the Glass-Steagall Act of 1933) gave national banks the right to branching as allowed to state-chartered banks in that particular state.

Another way for banks to move across state lines was the bank holding company. Such a holding company "could own and operate subsidiary banks in any number of states" (67, p. 79). Naturally, size became a concern in such cases and the Glass-Steagall Act called for some regulation of the holding companies by the Federal Reserve System (67, p. 79).

Nothing notable was done until the passage of the Holding Company Act of 1956 in which the Federal Reserve

Board increased regulations for holding companies and required approval of future purchases made by these companies--both bank and nonbank. The Douglas Amendment stopped holding companies from buying banks in more than one state unless state statutes specifically allowed that possibility. Additional amendments to the 1956 law were passed in 1970, further regulating the activities of bank holding companies, thus creating conditions increasingly hostile to the bank holding companies (67, p. 80).

States had the right to allow out-of-state holding companies to acquire banks, but were more involved in branching laws. Not until 1975, when Maine passed the first state law for "general entry" of out-of-state holding companies, was the provision of the Douglas Amendment exercised. Then, in 1982, Massachusetts passed a New England regional reciprocal agreement and New York adopted a nationwide reciprocal law (67, p. 80). By December, 1986, 36 states and the District of Columbia had passed some type of law permitting the entry of out-of-state holding companies. Of the remaining states, some allowed entry for the purpose of buying a failing bank or for some other specific, limited purpose (67, p. 80).

Although reciprocity agreements limit expansion, banking holding companies and interstate banking has been very successful. Up to now, the most popular form of entry has been the acquisition. Bank start-ups have been

far less popular, partly because the interstate banking laws restrict this form of entry (67, p. 83).

Two major concerns have come out of the rapid increase in interstate banking. The first is the fate of the unit bank, commonly called the community bank. Senator Proxmire, Chair of the Senate Banking Committee, is a strong proponent of the community bank (55, p. 30). Savage felt that community banks will continue to be competitive despite the changes in interstate banking laws (67, p. 91).

The second concern is the same concern that initiated the laws restricting and regulating bank holding companies passed in 1956 and 1970--the power that comes with increased size of monetary institutions. Even now, laws are being considered to limit the size of these holding companies although the mechanism and measurement have not yet been decided.

In conclusion, interstate banking is a growing phenomenon whose total impact cannot be realized until all of the laws pertaining to it are phased in. How it will change the face of competition is uncertain, the only certainty is that it will.

Economic Factors Affecting the Industry

While there are several economic concerns such as inflation, growth, and monetary policy that have always

affected the banking industry, the major concern today is the health of American and foreign businesses. Many banks are in financial trouble because of bad domestic loans, particularly in companies involved in "energy, real estate, agriculture, and basic manufacturing" (6, p. 102. See also 78). Other industries that also seem to be causing problems are mining and shipping (6, p. 103. See also 78).

The financial condition of many corporations has not escaped the notice of Congress. Several firms have taken huge debt in an attempt to fight takeovers. Proxmire stated that "the country is much more fragile as a result of debt burdens" (55, p. 30). A recession would put many companies into bankruptcy. This, in turn, could have a profound affect on banks (55, p. 30).

Many banks have already failed due to problem loans, most of which were domestic. The problems are graphically illustrated in Figure 4.1. While in the 1970s, high inflation could be used to mask problems, the 1980s has been primarily an era of disinflation. A recession would signal the demise of many companies just surviving, and this would increase even further the number of bank failures (6).

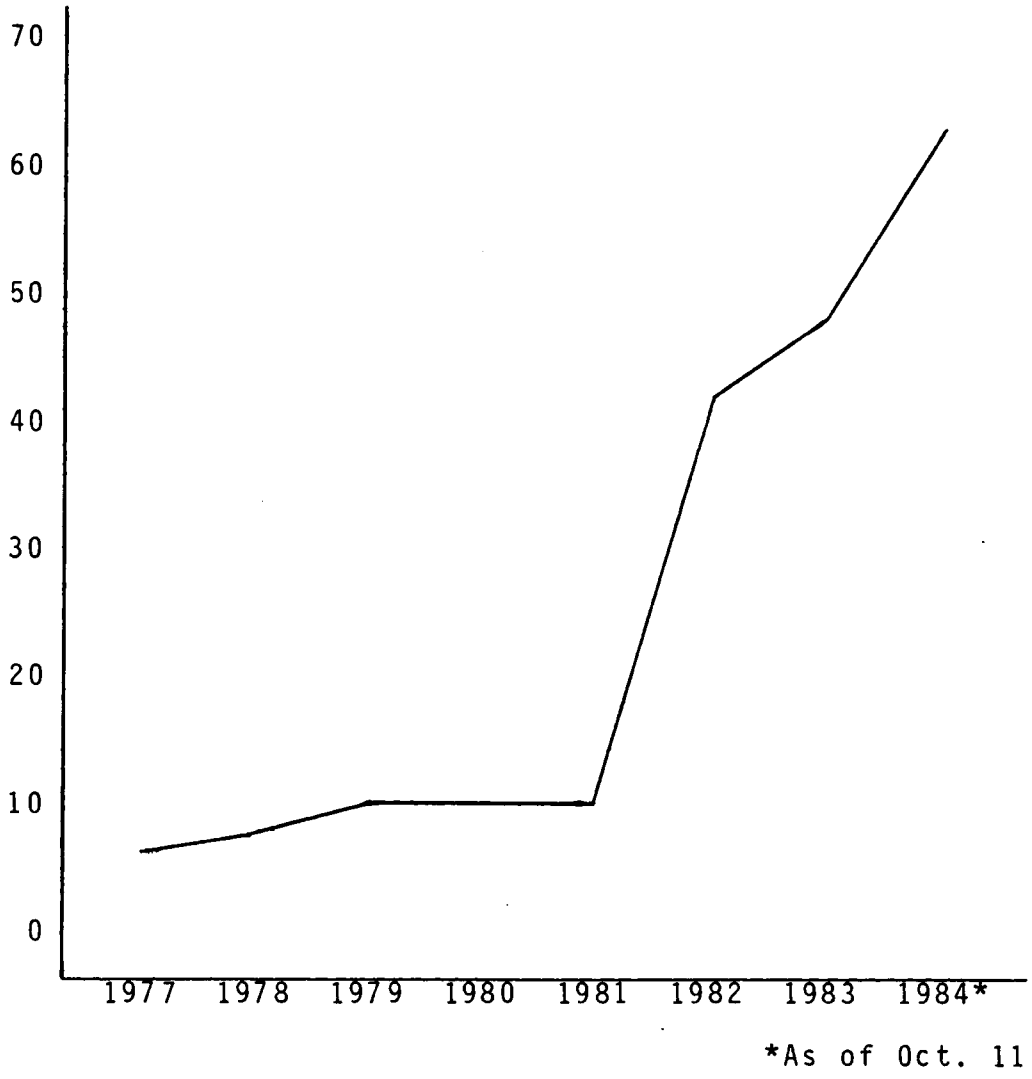


Figure 4.1. The Increase in Bank Failures From 1977 to October 11, 1984.

Source: Adapted from "Behind the Banking Turmoil," Business Week, October 29, 1984, p. 101.

Social Concerns in Banking

While there are several social issues with regard to banking, such as Truth in Lending and Equal Credit Opportunity, the most pressing issue of today is termed basic banking. Basic banking covers three areas: a safe and accessible place to keep money, a way to obtain cash, and a way to make payments to third parties (9, p. 256).

Taken cumulatively, the environmental forces discussed in previous sections have caused banks to begin to charge customers fees if customers are unable to maintain large minimum balances. This has occurred in part because the Federal Reserve now charges fees for services which were once free. But an additional factor is the realization by banks that fees are profitable.

Consumer groups, and in particular the elderly and poor, are being denied access to basic banking because of an inability to maintain the prescribed minimum balances. Some groups have put pressure on state and city governments to encourage banks to provide special lower cost accounts for the elderly. Although a handful of states (Massachusetts, Rhode Island, Illinois, Minnesota, Pennsylvania) have passed basic banking legislation at this time, federal legislators are becoming increasingly concerned about availability of services to the nation's poor (9).

With interstate banking and increased competition from nonbanks, basic banking will become more of a concern.

Summary and Conclusions

Numerous changes in the financial services industry have occurred in the past ten years. In particular, political/legal, competitive, economic, and social concerns are areas of the greatest change. The drastic change in economic conditions from the 1970s to the 1980s and the creativity of firms in circumventing banking regulations through utilizing a nonbank form and bank substance caused a flurry of merger activity due to bank failures.

To attempt an accommodation of these changes and a solution to the problems, Congress passed DIDMCA in 1980--the most sweeping reform of the banking industry's structure since the 1930s.

While DIDMCA did alleviate some problems, several more problems have been left untouched. Of these, nonbanks is the most dire, for several reasons. Not only do nonbanks circumvent the law, they run unfettered by the regulatory agencies intended to safeguard the public and the national economy. Deregulation of airlines and trucking is not as important as re-deregulation of the institutions that affect our national integrity. And,

with national interests in mind, how much of our banking business should be conducted by foreign owned banks?

Both foreign banks and nonbanks have had unfair advantages over real banks because they have been virtually free from the restrictive regulations to which real banks are subjected. Banks have been pressing for relief from this unfair competition, and Congress will probably address these issues under the leadership of Senator Proxmire.

Interstate banking has proven to be popular although not all states have allowed banks from every state to enter. Many laws are passed but not yet in effect, and many states have reciprocal agreements. Both of these facts severely curtail interstate activity--it is not "free enterprise" as much as it initially appears to be on the surface. Because change is the norm with regard to interstate banking, the type and extent of competition is as yet an unknown.

But interstate banking will likely have the same effects that deregulation in the airline industry did--few, larger companies with more power and less competition. This potential concentration of power has its dangers. When big banks fail, the repercussions are very severe. These repercussions have already been evidenced when big banks have gone under. Considering the concern over domestic

loan portfolios, the implications for the economic health of large banks is magnified.

Concentration of power also causes problems for a certain class of bank clientele--the marginally profitable customer. If there's only one bank in town, and the fees are high, a portion of the population will be denied services. Community banks may be either squeezed out or bought out, leaving no one to be concerned about the small depositor. Since banks are subsidized--through inexpensive deposit insurance and other below-cost services--they have an obligation to provide basic banking.

Although planning in the banking industry becomes more important, it also becomes more difficult. Compounding the problem of moving out of a protected business environment into the arena of fierce competition is the fact that the external environment is turbulent and volatile. The companies presented in this study have all been using planning within the protected environment. They will continue to utilize planning, but representatives from all of the firms pointed out that, for them, the useful planning horizon has changed. In a regulated environment, long-term planning was about five years; now it is three. All concur that a five year plan is done, but is not very useful.

Additionally, environment scanning of external factors is vital. All of the companies now hire a consultant for some capacity to assist with environmental monitoring, but discussions with officers clearly indicate that they also take a very active role in this regard. To give an example, the President of Company B said that auto loans used to contribute significantly to the bottom line, but the nonbanks (auto companies, in this case) have taken a large portion of that business away. With regard to the change in tax law, he/she remarked that the loss of IRA money will impact the bank over the next five to ten years. Officers of Company A and Company B made similar comments indicating they, too, are very involved in monitoring relevant external environmental factors.

As this very abbreviated description of the industry shows, banks today are no longer operating in a protected environment (see Table 4.2 for a summary of these environmental changes). Planning at the corporate, business and functional levels now becomes important. Getting people to follow through with the plan is equally important.

Table 4.2. A Summary of the Major Recent Changes in the Environment in Which Banks Do Business.

Area of Environment	Change
Political/Legal	· Passage of DIDMCA in 1980
Competitive	· Increase in foreign bank offices open in USA
	· Increase in type and number of nonbanks
	· Increase in interstate banking activities, resulting in increased merger and acquisition activity
Economic	· Many previously profitable domestic industries to which banks made loans such as energy, agriculture, real estate are not in trouble
	· Increased debt burden taken on by corporations to fight takeovers
Social	· Increased fees may make basic banking unavailable to some groups
	· The chance that community banks, serving local businesses and small depositors, may be an endangered species

CHAPTER 5

RESULTS OF THE STUDY: CASE STUDY A

In each of the following three chapters, case studies were analyzed by compiling the information from several sources. Interviews with members of the organization and with others who had knowledge of the firm, internal documents, public documents, and articles in the press composed the various sources. As was suggested in Yin (81, p. 92) case studies should not consist of raw data in aggregate. Rather, case reports should be, and in this study were, constructed from several sources simultaneously. Therefore the case reports which follow are compilations. This is an important distinction, and one that serves to enhance the validity of the study through multiple sourcing (81, p. 91). Additionally the compliation serves to protect individuals interviewed as the identity of an individual can be masked in this way.

As per agreement with the firms, specific information which would pinpoint the identity of the firm has been omitted. The author has agreed that under no circumstances are the names of either the individuals interviewed or the companies who participated subject to disclosure. Where an individual has given a response with which he/she does not wish to be associated, even the

position will not be identified. The companies are known as Companies A, B and C, respectively.

Company A was much larger than Companies B and C, and had a compensation plan which included many more levels of management than either Company B or C. In fact, a representative of Company A contacted the researcher for a return interview when additional participants were included in their strategic compensation plan.

Analysis of Case Study A

This analysis is comprised of the following sections: data collection, background information, strategic management history, and strategic compensation history. Following the analysis are the answers to the research questions and propositions.

Data Collection.

The data collection procedure consisted largely of interviewing and the utilization of other sources of information. On an average, interviews conducted lasted one hour. The major exception was that the interviews with the Vice President of Human Resources lasted an average of one and a half hours. Three such interviews were held with him/her, in addition to several call backs. The topics discussed were decided by the position of the individual being interviewed. In Company A, interviews were held with:

(a) the President and Chief Operating Officer (COO),

(b) the Vice President of Human Resources,

(c) Employee A,

(d) Employee B and,

(e) an Outsider, who had knowledge of the company.

Employees A and B were not upper management, but were participating in the short-term bonus program. Both could be roughly categorized as Assistant Managers.

In addition to these sources, documents provided by the Vice President of Human Resources, and newspaper articles were utilized.

Background Information.

At the time the data was gathered, Company A was a federally-chartered bank. While having a strong presence in the immediate area surrounding the bank's headquarters, the year 1982 was one of radical structural reorganization and changes in strategy. The reorganization and change in strategy were a direct response to volatility in the external environment -- namely deregulation, a deterioration in the national economy, and an unstable international economy, especially in the countries located south of the United States.

Prior to the reorganization, the company measured success by calculating total corporate profit/loss with less emphasis on the contributions of specific business areas. Reorganization was carried out to serve customer

groups better during a period of changing characteristics within the financial services industry, and to enable a more objective evaluation of performance based on profit/loss of each division. The establishment of these new divisions, deregulation, and the economy all had an adverse effect on earnings in the year the reorganization took place.

The altered structure of the firm can be observed by comparing the structure of Company A in 1981 (see Figure 5.1) with its structure in 1982 (see Figure 5.2).

The change in strategy was to target specific customer groups as is reflected in Figure 5.2. The location of several of the new subsidiaries was outside of the original geographic area which Company A served. Table 5.1 shows the additional geographic regions served by Company A as a result of the addition of the new subsidiaries.

While the restructuring and new strategy in 1982 were major events, Company A had yet a larger change looming in the immediate future. Joining the ranks of many other banks in New England, Company A was about to be acquired by a larger bank holding company with vast resources. Preliminary negotiations for the acquisition began in the Fall of 1983, but were stymied by litigation. In some part, the acquisition was challenged by stockholders who

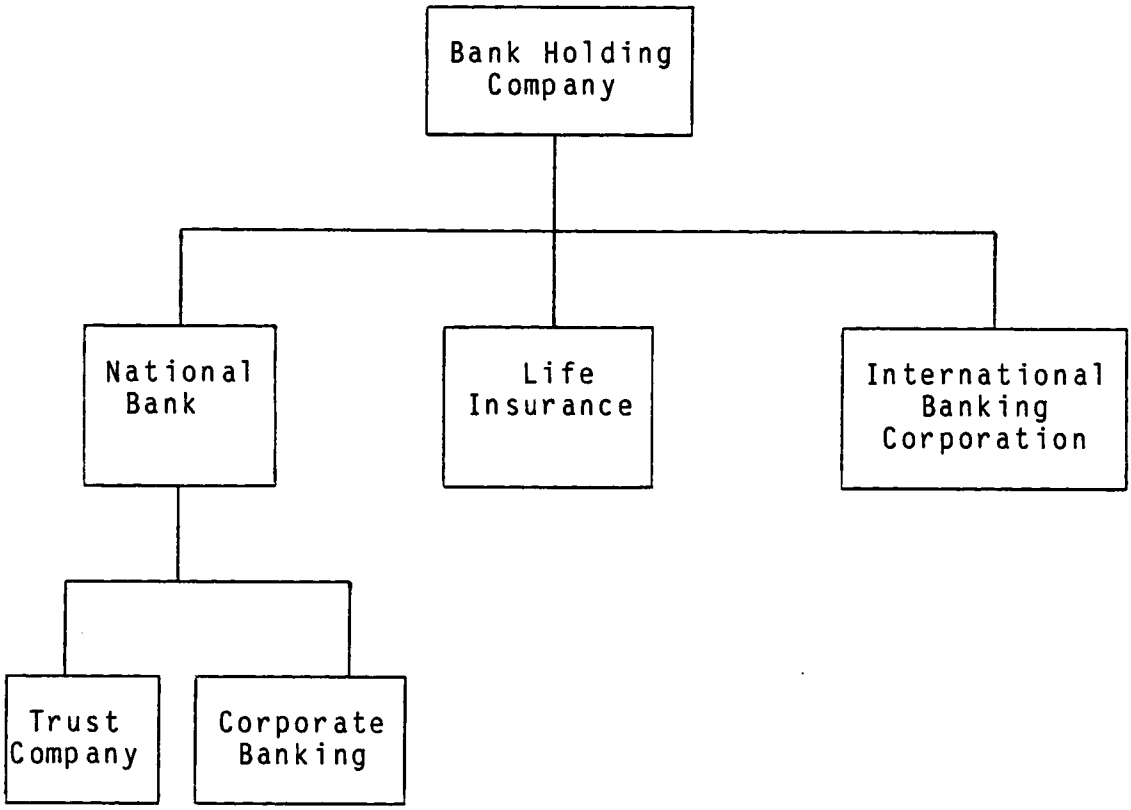


Figure 5.1. The Structure of Company A in 1981 Showing the Limited Number of Subsidiaries.

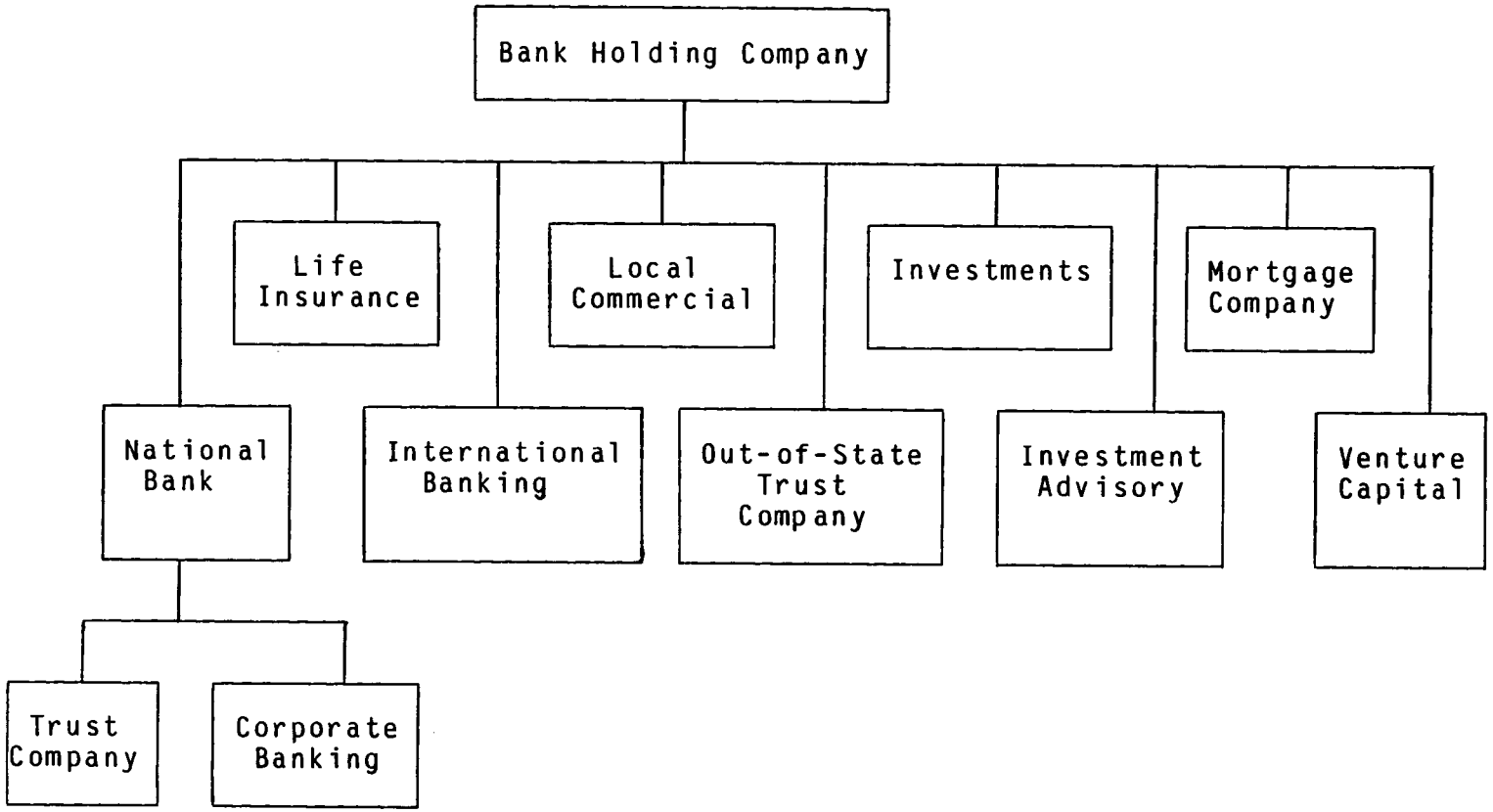


Figure 5.2. The Structure of Company A in 1982 Showing an Additional Six Subsidiaries Since 1981.

Table 5.1. The Additional Geographic Areas Served by Company A As a Result of Reorganization and Strategy Change, 1982.

Subsidiary	Regions Served
Venture Capital	Local/Ohio
Mortgage Company	Local/New England/ Southeastern United States
Trust Company	Florida
Commercial Bank	Local/Southern New England

did not want to see a local company bought out by a larger firm. Other suits were brought by firms who were similar in size to the firm acquiring Company A. These firms were attempting to block the acquisition for obvious reasons of the resulting strategic advantage which would accrue to the firm trying to buy Company A. A statement from the 1985 Annual Report of the acquiring firm supported the contention of this strategic advantage:

> During 1985, your Corporation completed its current New England acquisition program, giving us a strong presence in each state that allows interstate banking. As a result, we made significant progress toward solidifying our strategic objective of being the pre-eminent financial institution with headquarters in New England.

How and where Company A fits into the structure of the acquiring firm is shown in Figure 5.3.

Financially, Company A has grown in asset base, but has had variable net income. The increase in total assets was part of the aggressive growth strategy that is seen in Figure 5.2. According to the 1982 Annual Report of Company A, the poor financial performance was due to both the external environment and the cost of carrying out the strategy. Figure 5.4 shows the percentage increase in total assets from 1979 to 1984. (Because Company A was acquired in 1985, the last available annual report for Company A was 1984.) Figure 5.5 shows the percentage increase and decrease in net income from 1979 to 1984.

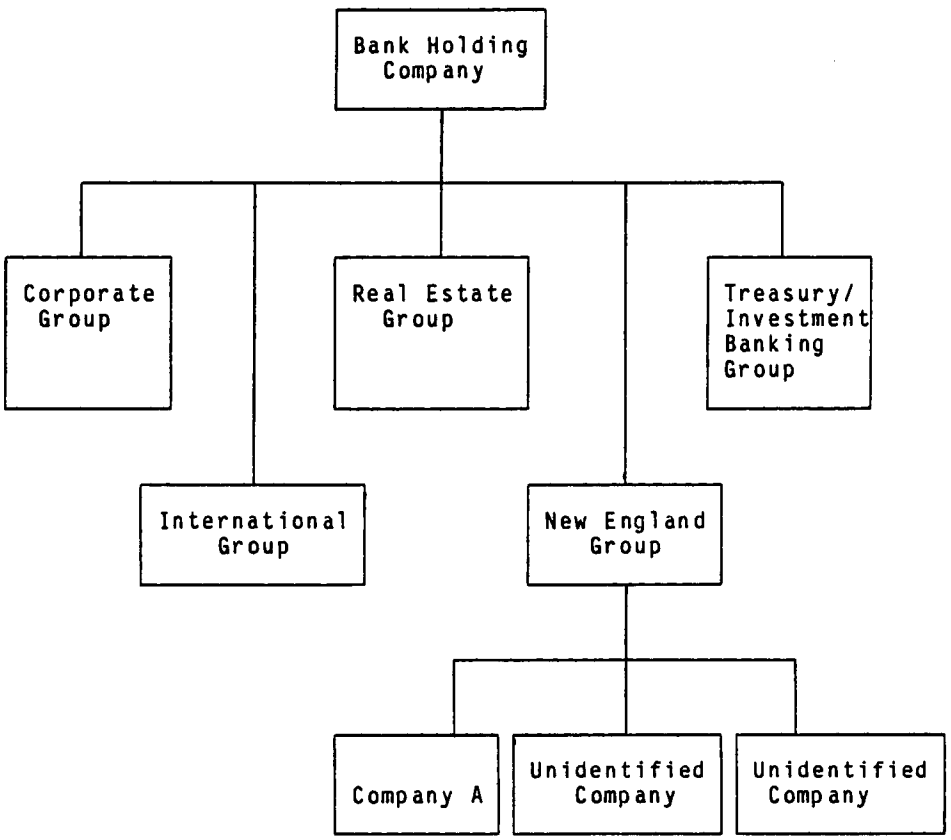


Figure 5.3. Company A Is Shown As Part of the Structure of the Firm Which Would Ultimately Acquire It in Late 1985.

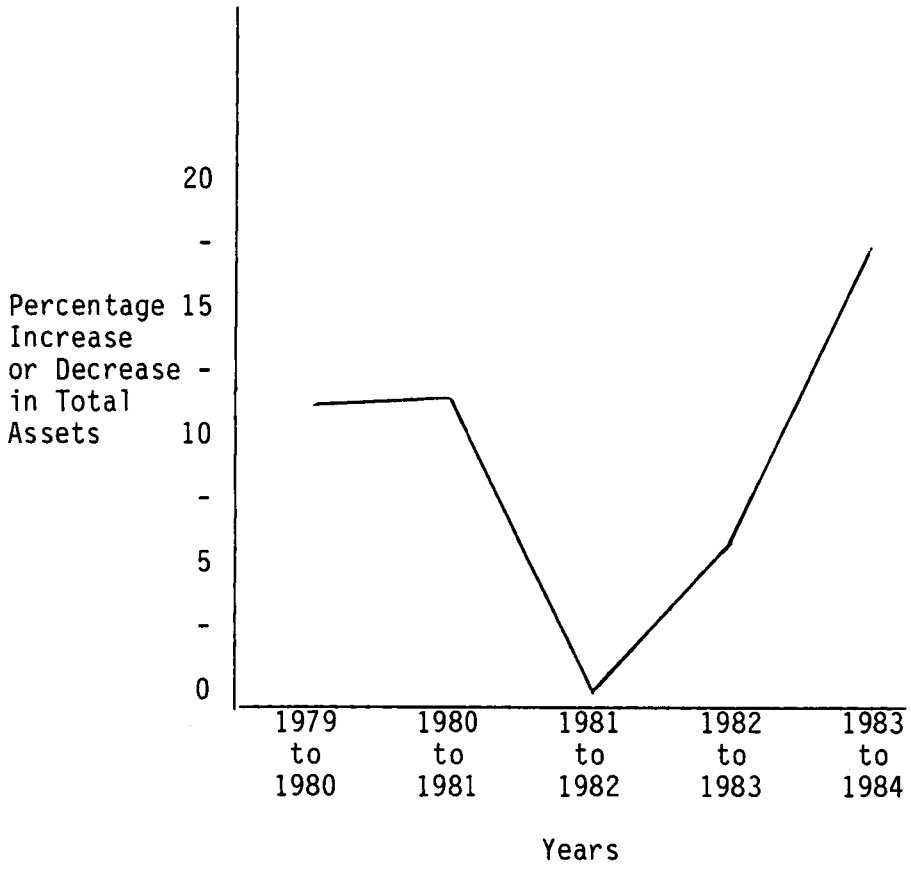


Figure 5.4. The Percentage Increase or Decrease in Total Assets for Company A from 1979 to 1984.

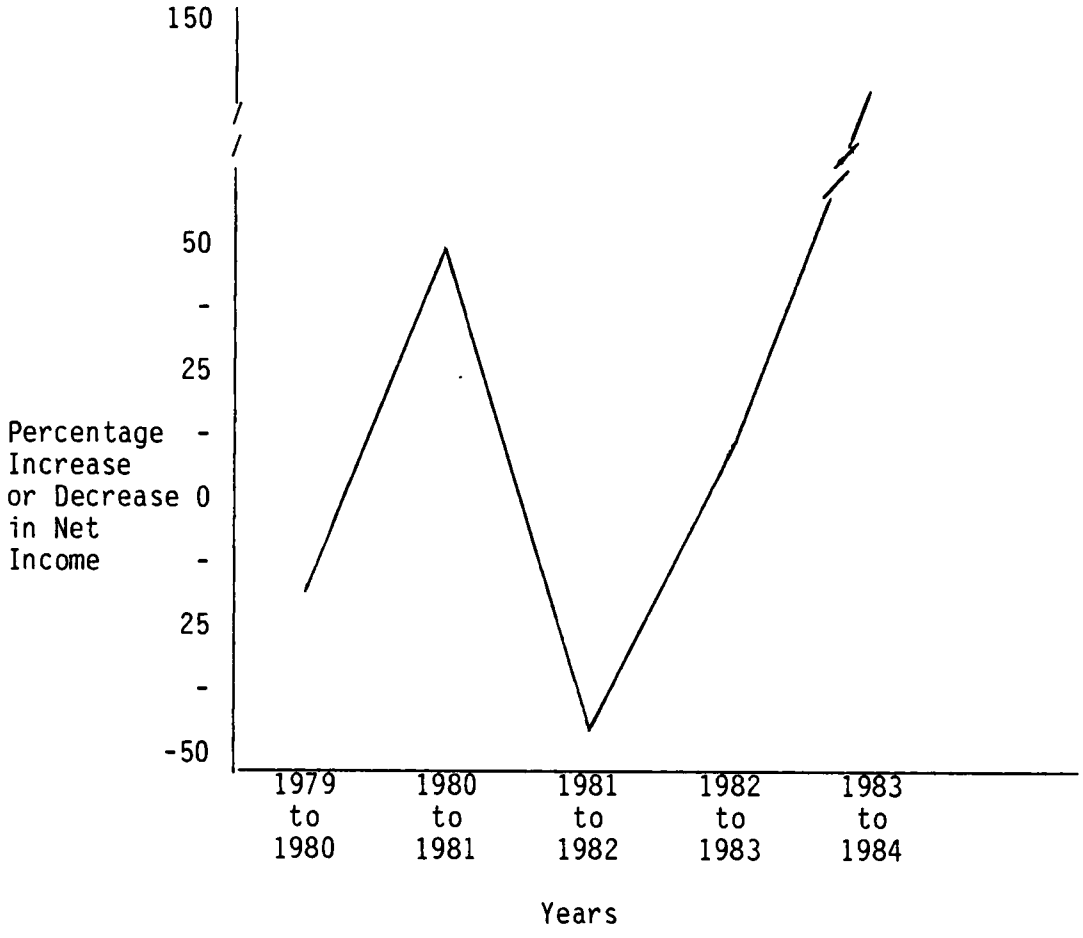


Figure 5.5. The Percentage Increase or Decrease in Net Income For Company A From 1979 to 1984.

While merger and acquisition activity is high in banking, the acquisition of Company A was completed for deliberate strategy purposes and not as a result of the bankruptcy or impending bankruptcy of Company A. To illustrate the vast potential financial backing of Company A, now that it has been acquired by a larger firm, the total assets of Company A are approximately 10 percent of the total assets of the acquiring firm.

In summary, Company A was a well established, well respected financial institution prior to the acquisition. Although most of its business activity was conducted in the region in which it was located, the bank also had loans to foreign countries, to businesses and to consumers outside of the region, and subsidiaries, which were located outside of the region. In other words, Company A had the image of a sophisticated commercial bank.

Now that Company A has been acquired, objectives and strategies are controlled by the parent company. The research conducted in Company A was begun before the acquisition was finalized, but it must be noted that Company A will be operated as an independent subsidiary of the parent firm.

Strategic Management History.

The company began its planning ten years ago and hired a consultant to begin a planning effort because the first attempts at planning failed. Upon the

recommendation of the consultant, a department of corporate planning was created. The purpose of that department was to carry out the external environmental analysis for all departments, to help develop marketing (business level) plans, and to teach and encourage planning throughout the organization.

Even with the creation of the corporate planning department, the company had difficulty initiating effective planning. There was uncertainty as to what the actual (as opposed to nominal) tasks of the corporate planning department would be. A coordinated, integrated plan was not forthcoming.

Within the department of corporate planning, planning was an annual activity which occupied six weeks of time and vast volumes of paper. However, the task was so odious and nerve-racking that it was difficult to even look at the plan for three months after it had been completed. Mostly, the volumes gathered dust while people went about their routine daily activities. Planning had become an end, rather than a means to an end.

Five years ago, the chief executive officer (CEO) and chief operating officer (COO), with agreement from the board of directors and division heads decided (a) that the CEO and COO were ultimately responsible for corporate level planning; and (b) that they were doing most of the planning anyway. Because of the obvious lack of value of

an activity which kept people busy for six weeks but provided no further benefit, the corporate planning department was dissolved and most of the staff were fired.

This began a new era in the company with regard to long range planning and the management activities which resulted. Planning was now decentralized along with responsibility for the achievement of objectives. The result was the current strategic planning process which is described in the next section.

The Planning Process.

At the corporate level, a five year rolling plan was used. The first three years were developed in detail, while years four and five were more general. The mission statement was used as the guideline for what is to be done in the long-term. In order to redefine the business of the company, the board and top officers have recently revised the mission statement. Components of the redefined statement included (a) a redefinition of the market served (enlargement), (b) emphasis on quality and value, and (c) concern for people inside and outside of the company, for technological advances and for ethical business behavior. The mission statement is reflective of the style and attitude of the board and top officers and is supposed to permeate the organization. All corporate, business and functional level plans were to be developed with the content of the mission statement in mind.

At the corporate level, the executive officers develop certain financial and qualitative objectives. These objectives are largely based on the mission statement. After corporate objectives are established, a determination of how each division or Strategic Business Unit (SBU) will contribute to the achievement of these objectives is made. The executive officers decide what these objectives will be. Each division is "handed" what financial and qualitative objectives are to be attained by them. While there is some room for negotiation, the corporate officers are cognizant of the capabilities of each SBU. Because these SBUs are related, corporate management understands and is familiar with each type business and can make informed decisions as to what is achievable.

The COO made note of one recent change in the formulation of objectives. Apparently, some of the objectives which were handed out in previous years were set artificially high in the hope that this would encourage better performance. This did not work as planned and subordinates became discouraged. Now attainable objectives are set, and the COO felt this would encourage a better effort to reach goals.

While the seven line divisions in the company were related, they were operated as independent businesses with their own planners. When plans were developed, those

external factors which were important were identified and monitored by that division. For instance, the out-of-state mortgage company monitors the regional economy, housing starts, and net migration figures. Both internal and external factors were considered in a situational analysis.

The responsibility for forecasts was tremendous as there was not much "leniency" for factors beyond the immediate control of the division. The CEO and COO have very strong feelings about risk as was evidenced in the following discussion. Division heads are paid to do their job and they are not allowed to curb risk deliberately in order to look good. In other words, setting objectives artificially low to avoid looking bad was not acceptable. The COO felt that division heads know their jobs entail risk, and they are being paid to take intelligent risks.

Each division develops its own marketing plan. A unique style of leadership exists in each division. The CEO, COO and board feel different styles are necessary to operate the different businesses.

An integral part of the planning process in Company A was budgeting. The CEO and COO used budgeting sessions to emphasize productivity and quality (as opposed to quantity). Budgeting sessions held between department heads and the CEO and COO seemed to require much preparation on the part of the department heads. These

sessions also appeared to cause much concern for department heads, as "they have to justify every cent".

The COO confirmed that he/she is tough on department heads for several reasons. First, good budgeting indicates that department plans are well thought out. Second, the tense atmosphere of the budgeting sessions forces department heads to think through potential problems causing the identification of the problems and the probability of occurrence to be completed. Third, since zero-based budgeting[1] is used, every item must be justified. In a budgeting session, the COO said that one of his/her favorite questions is "If you had to do without one employee, who would you choose to be fired?" The department heads know that this type of difficult question is the norm for budgeting sessions -- and sometimes they are asked spontaneously, throughout the year, to keep people thinking about reaching objectives.

In summary, this company meets the criterion for using strategic management based on the definition of strategic management used in this study. The COO believed the firm to be strong in strategic planning and that the emphasis on planning is due to recent deregulation in this industry, a more unpredictable economy and new employee

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[1] Zero-based budgeting requires that all items be rejustified each year; there is no automatic renewal of any item in the budget.

values. Further, the COO expected strategic management to become more important in light of increased competition resulting from deregulation. Further refinements of the planning process were expected to occur in the future.

Strategic Compensation History.

In 1982, this company's Human Resources Division was charged with the development of a new incentive system -- one that would better reinforce the achievement of corporate, business and functional objectives. Prior to the development and approval of this plan, a very small number of officers were awarded incentives based solely on corporate profit/loss figures for the year. In other words, only a small number of top executives received any performance-based bonuses, and these bonuses were for short-term performance only. How much was awarded was somewhat more subjective than the current plan.

The new plan, called the management incentive plan (MIP), is much more structured, more objective, and clearly related to the achievement of corporate objectives, both short-term and long-term. The second component of the new compensation plan increased the number of participants from 38 to 132. The Management by Objectives (MBO) component, currently being put into place, will add another 138 individuals to the overall system. (These additional 138 will not be part of the

MIP, but will only participate in the MBO component of the plan which will be explained subsequently.)

The revamping of Company A's executive and management compensation plan was, in itself, a long-term project. Over a three year period, three phases of the plan have been instituted. The phases were: (a) the institution of a long-term management incentive plan for the executive officers starting in 1983, (b) the development of a management incentive plan (MIP) which included the long-term component as previously defined and the addition of an incentive bonus for a larger number of individuals in Fall 1985, and (c) the Corporate Compensation Plan (CCP), an MBO type plan for an even greater number of persons that was developed in 1986. An outline of the plan's components can be seen in Table 5.2.

The theory behind the development of the MIP is a belief on the part of executive officers and the Vice President of Human Resources that people do perform better if they have a chance to earn a hefty bonus based on pre-agreed goals. Base salaries are considered essential for living and the COO believes a raise in base salary has a very short-lived impact on productivity. Base salaries are comparable to other similar firms; employees are not "kept hungry". However, the company feels that the chance for a large bonus does help people perform better. Although there is some room for subjectivity in awarding

Table 5.2. The Revamping of Company A's Compensation System Included Hundreds of Additional Participants in Two Main Segments of the Overall Plan Which Are Summarized Below.

Segment	Number of Components	Description of Components
Management Incentive Plan	2	MIP (a) developed in 1983, long-term (3 years) includes top executives only, stock option. These executives also participate in MIP (b). MIP (b) developed in 1985, short-term, includes about 130 people, cash bonus.
Corporate Compensation Plan	2	CCP (a) developed in 1986, short-term, includes 138 people (exclusive of MIP participants), cash bonus. CCP (b) a continuation of MBO (a), but adding more employees in 1987

bonuses, the MIP is much less subjective than the old plan. While subjectivity is usually thought of as an opportunity to discriminate against specific individuals, in this case, the subjectivity may allow flexibility in cases where SBU's get hurt by unexpected external events.

The Management Incentive Plan (MIP). The short-term component is discussed first; the long-term component will be discussed second. Those top executives included in the long-term component are also included in the short-term component. Top executives are eligible for both a short-term and long-term performance based bonus. In other words, the total bonus paid includes a portion based on reaching short-term goals and a portion based on reaching long-term goals.

The short-term component. The short-term component, which went into effect in 1986, covers 138 individuals in Company A. The bonus given is cash which is based on short-term (one year) performance. During the time the MIP was being designed, the question of including staff as well as line arose. Ultimately, staff members were included in the plan because they, too, were felt to be important in achieving overall corporate success.

There were four basic considerations in determining an individual's bonus. These were corporate performance, SBU performance, department performance, and individual performance. (In the MIP plan, individual performance was

called MBO performance. At the time this designation was given, the MBO segment of the plan had not been designed.) These four considerations can be broken into two parts -- individual performance and the performance of a group in which the individual works. The fact that group performance was evaluated reflected the belief of the designers of the system in the importance of teamwork. Ultimately, this was supposed to reinforce corporate objectives.

Although all individuals were evaluated on these four considerations, the relative importance (weight) of these considerations depended on the respective position an individual holds. Individuals who held the lowest level positions included in the plan could not significantly impact either the performance of the corporation or the performance of their division. The bonus of such a person would reflect this fact as their individual and departmental performance would be more heavily weighted on these two factors in determining their bonus. This makes sense because an individual can control their own performance and can contribute significantly to the performance of their department. The bonuses in this case would be based on: corporate performance, 20 percent; SBU performance, 20 percent; department performance, 30 percent; and MBO performance, 30 percent.

The head of an SBU, however, would not have his/her MBO performance emphasized and would not have his/her department performance considered because an SBU head is not a member of a department. SBU performance is his/her prime responsibility and this performance counts heavily in determining the bonus. Since an SBU can directly hurt or help corporate performance, this, also, is counted considerably in determining a bonus. The bonus of a line SBU head would have his/her bonus based on: corporate performance, 30 percent; SBU performance, 50 percent; and MBO performance, 20 percent.

The MBO component of the MIP at the lowest level is based on individual agreements between department heads and their subordinates. The entire department is apprised of departmental objectives and the strategy to be enacted to achieve these objectives. Then the department head meets with each individual to formalize a written agreement of four objectives to be accomplished in the coming year. Each person is also asked to weight the importance of each goal. Both the superior and subordinate must agree on the content of the contract. While there is a midyear review, performance is not actually judged until the year is over.

Individuals are rated by their immediate superior. (People involved in making MBO performance decisions are required to attend classes to educate themselves as to how

to rate performance.) Each subordinate receives a rating from one to six. Only those persons who receive a rating of 4 and above qualify for an incentive bonus. Those persons who do not get at least a rating of 4 will not be eligible for any incentive bonus for that year. The Vice President of Human Resources commented that in Company A, someone who receives a rating of 6 walks on water while someone who receives a 1 passes water. The variation in payout for MBO ratings can be seen in Table 5.3.

While the MBO component was developed to exclude the possibility of slackers getting an incentive bonus, the MIP also includes department and SBU components to encourage a team effort. At the department level, the SBU head determines how well each department has contributed to the achievement of SBU's goals. For each department, the payout percentage is determined by three things: "difficulty factor, earnings potential, and earnings volatility". Four levels of performance qualify the department to earn a bonus, and the levels of performance are determined by the comparison of actual results with preestablished goals (see Table 5.4). The percentage of actual achievement for each level of performance was confidential and could not be disclosed.

SBU performance is judged by the same four levels of performance with the same payout ranges. Again, the actual percentage of target for each level of performance

Table 5.3. Variations in Pay-Out for Management by Objectives Rating In the MBO Component of the MIP in Company A.

Rating[a]	Description	Payout in Percent
4.0	Good	33
4.5	Good Plus	50
5.0	Superior	67
5.5	Superior Plus	83
6.0	Outstanding	100

[a]While ratings under 4.0 are given to plan participants, no payout is made for such ratings. No formal descriptions of such ratings were disclosed.

Table 5.4. SBU and Department Payout Ranges According to Performance Levels in the MIP of Company A.

Levels of Performance	Payout Range in Percent
Threshold	20 - 30
Target	40 - 55
Above Average	60 - 75
Outstanding	80 - 100

was confidential and could not be disclosed. However, an illustrative fictitious example of how this works can be given (see Table 5.4 on page 159).

Target could represent the achievement of the specified objective. Reaching the objective does not guarantee earning 55 percent of the available bonus. The difficulty factor, earnings potential, and earnings volatility are considered when deciding the payout. If a favorable economy boosted performance, then the payout would be less than if the objective were achieved in an unfavorable economy.

The COO and President are responsible for the determination of SBU performance and the Board of Directors determines the performance on the top officers.

The long-term component. The long-term component of the MIP is reserved for the executive officers of the company. The commencement of this segment of the MIP is noted in the 1984 Annual Report of Company A, "Also in 1983, the Corporation instituted a long-term management incentive plan...for certain members of management." The Annual Report goes on to say the awards were earned under this plan in 1983, but not in 1984.

The primary differences between the long-term and short-term component of the MIP are time, the nature of the award and the determination of performance. The long-term bonus is the awarding of restricted stock options

rather than cash. The determination of performance only looks at corporate performance and does not consider SBU, department, and individual performances as they are not relevant.

The Board of Directors is responsible for the determination of top officers' performance. Again, the objectives are compared to actual performance, to ascertain the applicable payout range. Within that range, earnings volatility, difficulty factor, and earning potential are used to arrive at the final payout.

The Corporate Compensation Plan (CCP). The MBO segment of the revamping of Company A's compensation system is an attempt to push the ultimate responsibility for achievement of corporate objectives further down into the organization. In the "Implementation Guide", the section on objectives instructs superiors to review business level plans with each subordinate who is a participant in the CCP. The purpose of doing so is to make participants aware of the unit's direction and how the participant's objective should reflect this. Weighting objectives is required to force prioritizing. A copy of the Objectives Planning Worksheet used to help participants develop objectives can be seen in Figure 5.6.

In addition to objectives setting, the process also includes monitoring the objectives. This is done bi-annually. The mid-year review allows for reprioritizing

OBJECTIVES PLANNING WORKSHEET

Objective:

What is it you wish to accomplish? State objective. Weighting Priority ( )

Measurement (Quantity, Quality, Cost, Time):

How will achievement of objective be measured?

Performance Criteria:

Target (4)

Superior (5)

Outstanding (6)

Conditions and Assumptions:

Figure 5.6. The Objectives Planning Worksheet Utilized in the Corporate Compensation Plan of Company A, 1985.

objectives because of new data and/or a change in the strategic direction of the unit.

The performance review is based on objectives set in the previous year. In order to qualify, participants must achieve a designated percentage of their target objective.

The overall performance rating is calculated by multiplying weight of the objective times the performance rating. These ratings are summed for a total and then adjusted up or down based on the "difficulty of the objectives or other performance factors." The maximum adjustment is 20 percent.

Strictly a short-term cash annual incentive, this plan incorporates an additional 138 individuals into the corporate incentive plan. As far as operation, the CCP, is virtually identitical to the MBO component of the MIP incentive plan for top executives. In 1987, the company plans to add more employees to the list of those eligible.

In summary, the incentives system of Company A as it stands today began the first segment of its operation in 1983 with the initiation of the long-term management incentive plan for top executives. Other executives and managers were included in the second component of the MIP, a short-term cash bonus plan which started in 1985.

Because the management of Company A believed strongly in the power of a bonus to motivate individuals to perform better, the Corporate Compensation Plan was developed in

1986 to include "key managers, account managers and staff" -- an additional 138 people with more to be included in 1987. This plan is a short-term, cash bonus plan. Bonuses are based on the level of performance attained in comparison to pre-determined objectives contrived by the individual participants with the consent of their superiors. The purpose of this plan is to reward good people and to educate these people as to the business plan and direction of their SBU.

Research Questions and Propositions

Research Question I.

The major area of concern in Research Question I was the determination of the external and internal factors considered in strategic management and how these factors were handled.

Proposition I.1. Proposition I.1 was specifically concerned with the identification of external variables which will affect the SCP. The proposed variables are industry, compensation systems of competitors in the same industry, and economic conditions, particularly inflation and tax laws.

For the long-term executive component of the MIP, the industry and general economic conditions affect the formulation of long-term objectives for the corporation. The goals of the corporation are the goals of the top

executives. Therefore, if the conditions of the industry are poor, and the general economic forecast is poor, the long-term objectives of the corporation and the top executives will be less ambitious than if both the condition of the industry and the general economy are good.

In terms of pay equity within the industry, and utilizing information concerning competitors compensation systems, this is applicable to Company A. The firm wishes to retain its top management. Although long-term components are not common in the geographic area in which Company A is located, the firm which acquired Company A has a long-term component as well.

Inflation and tax laws are also inputs, but inflation is not an important consideration for the long-term component at the present time. Inflation usually is addressed in base pay, not bonuses, and the inflation rate has not been high enough to cause problems in the last five years. Tax laws are very important, and are monitored carefully because historically changes can wreak havoc with incentives.

Both short-term, cash incentive programs (MIP and CCP) are affected by the industry. Company A wants to retain and reward good people. Deregulation has created more job opportunities for individuals who could previously only utilize their skills in banking. The New

England economy has made low end jobs difficult to fill, making it mandatory that positions be made more attractive. The CCP attempts to help do that.

Being competitive with those in the industry is vital, and Company A recognizes this. The fact that over 280 employees are covered by an incentive plan recognizes the need to be competitive.

Changing tax laws are posing some concern at present for the short-term bonuses. While at the CCP level it is not an issue, at the MIP level for higher level officers, it may well become an issue which forces the company to look for another way to reward their individuals.

In summary, the long-term component of the MIP is affected by the industry, competitors' compensation systems, and the economy, particularly tax laws. In the short-term component of the MIP and CCP, the industry, competitors' compensation systems, and the economy are important. For the CCP changing tax laws are not as important. See Table 5.5 for a summary of the external factors affecting the various components of Company A's incentive system.

Proposition I.2. The proposed internal variables which are thought to affect executive compensation are size of the firm, strategy and resulting structure, culture, and financial constraints (no particular order

Table 5.5. External Variables That Affect the Design and Administration of the Various Components of Company A's Incentive Plan, 1985-1986.

Component	Variables Which Affect Components
Long-term of MIP	* Industry * Competitors' Compensation Systems * Economic Condition * Changing tax laws
Short-term of MIP	* Industry * Competitors' Compensation Systems * Economic Conditions * Changing tax laws
Short-term of CCP	* Industry * Competitors' Compensation Systems * Economic Conditions * Regional unemployment rate

*Variables predicted and supported by the literature.

of importance suggested at the onset of the study). All of these factors turned out to be important in Company A.

Although no order of importance is postulated, Company A appears to currently find that strategy and structure and culture are extremely important. Part of the concern for these two variables comes from the aggressive growth strategy and reorganization which occurred in 1982. Prior to this time, Company A's performance was judged on corporate profit and loss. With the reorganization to true divisional structure, each division now has profit/loss responsibility. The compensation system reflects this change as the bonus of division heads depends largely (one half) on the division's performance.

The change to accountability has been well accepted by most divisions. There is one notable exception, a traditionally very conservative department, which was identified by the Vice President of Human Resources and confirmed by the Outsider.

The COO remarked that he/she thought culture would be more of a problem than it was. His concern was the bank had been operating in a regulated and protected environment so long that a change to an aggressive strategic posture might be resisted. With the exception noted in the preceding paragraph duly recognized, the people in the bank have responded positively to change.

Size of the firm is important in that Company A identifies its competitors by size. The company uses its competitors for comparative purposes in designing the compensation plans.

Although financial constraints were not discussed using that particular term, Company A, as previously discussed, has very demanding budgeting sessions. The researcher felt this to be an indication for concern over generating enough income to pay for the incentive plans.

In summary, all of the proposed variables were important in the design and administration of Company A's incentive compensation system, although some uncertainty about financial constraints must be noted. A summary of these variables follows in Table 5.6.

Proposition I.3. Forecasting of pertinent external variables which affect the compensation system is the focus of Proposition I.3. This is, in fact, true for Company A. External variables are monitored by divisions and by the corporate executives. Divisions monitor variables which are specific to their particular segment of the external environment. Since their performance determines their bonuses, they are held accountable for being aware of trends for their area, and must negotiate objectives given to them from corporate management.

In the CCP, forecasting is done less formally, and not as far into the future. In fact, the CCP, unlike the

Table 5.6. Internal Variables That Affect the Design and Administration of Company A's Incentive Compensation Plan.

Variable	Comments
* Strategy and Structure	· Recent reorganization brought about direct profit/loss accountability
* Culture	· Employees have responded positively to operating in a deregulated environment
* Size of the Firm	· Used to identify their Competitors
* Financial Constraints	· Tough budgeting sessions and no profit/no bonus formula make this variable viable

*Variables predicted and supported by the literature.

MIP, allows for reweighing objectives due to "unforeseen factors out of an individual's control."

At the corporate level, forecasting is done for three to five years. These forecasts are used to develop long-term corporate and executive objectives. The COO and Vice President both expressed concern over the usefulness of five year forecasts due to environmental volatility.

Proposition I.4. Strategic management connotes the use of monitoring the external environmental variables of importance to any particular firm, and also implies that a major change in an important variable may result in either a change in strategy or a modification of divisional or corporate performance objectives. Strategic compensation, in theory, would allow minimally, the recognition that major changes occur and affect the achievement of goals.

The CCP does allow for the bonus to be adjusted by ± 20 percent due to factors beyond the individual's control. Participants in the MIP are not allowed that grace. Once performance objectives are set, only minor adjustments in bonuses can be given due to difficulty factors, earnings volatility and earnings potential.

Summary. In summary, the first research question may be answered by saying that:

(a) The primary internal variables are strategy and structure, culture, size of the firm and possibly

financial constraints. The order of importance is suggested.

(b) The primary external variables are different for the various components of the company's incentive program, but include industry, competitors' compensation systems, economic conditions, especially changing tax laws, and for the CCP, the regional unemployment rate.

(c) Forecasting of variables is done primarily by employees of the firm.

(d) Changes in major variables can be somewhat accommodated in the CPP, but little or no accommodation can be made in the MIP as it now stands.

Research Question II.

The second research question focused on the design and operation of the strategic compensation system. Of concern is how the system is designed and operated within Company A.

Proposition II.1. This proposition asserts that designers of the executive compensation system are knowledgeable about corporate objectives and strategies designed to achieve them. At the time of the first field visit to Company A, an interview was conducted with the Vice President of Human Resources. In November, 1985, the design of the MIP short-term component had just been completed, but had not yet been presented for discussion

and approval by the Board of Directors. The appropriateness of the inclusion of Company A in this study was contingent upon the approval of the MIP by the Board.

As has been previously mentioned, the structure of the total incentive plan -- from President to account managers -- is such that corporate and business plans and objectives are made known to participants. The Department of Human Resources designed this plan in conjunction with the executive officers of the firm.

The primary designer of the MIP and CCP was the Vice President of Human Resources. He/she has knowledge of corporate objectives and corporate plans as well as the objectives and plans of the subsidiaries. This was made evident to the researcher during the interviews and was confirmed by the COO. Additionally, Employee A, who has occasion to interact with the Vice president of Human Resources as part of his/her job, also affirmed this.

Documentary evidence existed to prove this knowledge as well. Instructions for the individuals who have subordinates participating in the CCP clearly state that all MBO contracts must be sent to the Vice President of Human Resources for final approval. It is his/her job to read and check these plans.

Proposition II.2. The existence of points of information exchange between the strategic management

process and the strategic compensation is postulated. Such points of information exchange take place in formulation stage of the MIP and CCP. During the formulation stage of the strategic management process, corporate and divisional goals are established. The corporate goals and strategies proposed by the executive officers and approved by the Board of Directors, became the goals of the executive officers. Division heads are apprised of their objectives, and they are given an opportunity to negotiate the objectives which are handed to them by the top executives. Division heads, in turn, inform their immediate subordinates of the divisional objectives -- thus providing them with the information needed to formulate appropriate MBO objectives (see Figure 5.7).

During the implementation of the strategy, the company's formal control mechanism is the six month review. At this time, each subordinate and superior meet to discuss progress made and problems encountered toward reaching goals.

At upper management levels, progress is monitored both formally and informally. Meetings provide a forum for discussing progress toward goals and for looking for solutions to problems.

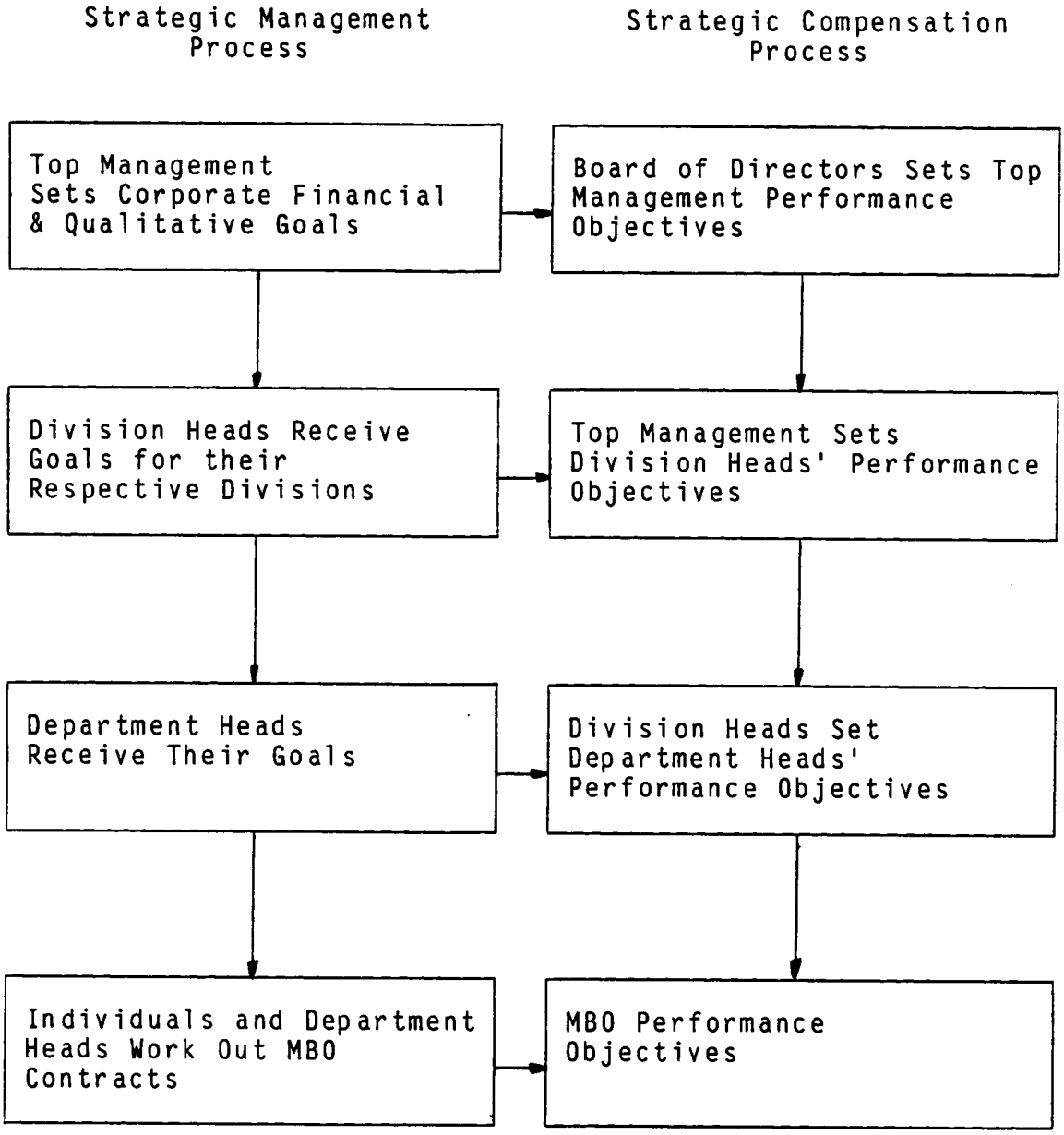


Figure 5.7. Information Exchange in the Formulation Stage of Company A, 1985-1986.

Formally, the comparison of objectives set and actual performance is reviewed. The Board of Directors is kept apprised during the year through quarterly meetings.

Because Company A's incentive compensation includes a large number of employees (about 280), the hoped for result is the constant awareness of all employees of where the company is headed and how it hopes to get there.

Proposition II.3. This proposition suggested that executives are made aware of corporate objectives and performance objectives, and people know how their performance will be evaluated. For Company A, this is the case for all the people included in the MIP and CCP. The Human Resources Department is responsible for instructions concerning how the plan works.

For each participant in the plan, the relevant objectives, weights, and values of results are spelled out as part of the agreement. For instance, the SBU heads know that their bonus is based on (a) corporate performance, 30 percent, (b) SBU performance, 50 percent, and (c) MBO components, 20 percent. He/she is also aware that if 90 percent of target is reached, the payout is a certain percentage of the incentive pool. Each executive is made fully aware of the way his/her own bonus is to be calculated.

One caveat must be noted. Employees A and B expressed some distrust of the system. Their concern was

the fact that participants are informed of their bonus calculations, but the calculations for all positions are not disclosed.

The Vice President of Human Resources responded by saying that the task of informing everyone would be too time consuming and that the emphasis should be on each individual's bonus.

Proposition II.4. In strategic management, a way must be found to handle problems that develop. A feedback mechanism is usually utilized to accomplish this. Proposition II.4 presumes that a strategic compensation system would have a formal mechanism for system improvement. This is not true in Company A.

A few problems have already appeared, the primary one being the type of measurement used in some of the divisions as standards for performance. Currently, these complaints are being handled on a case-by-case basis. Since the system is new, some type of mechanism will have to be developed to handle problems and suggestions.

The Vice President of Human Resources realizes that changes will have to be made, but some of these changes will have to be reviewed to preserve the integrity of the system. It is likely, considering the vast improvements made in planning over the last ten years, that real improvements will be made to make the compensation system reinforce the achievement of objectives. The company has

a President who seems determined to continually improve on the firm's performance through quality, specifically quality performance by employees at all levels, and he/she is committed to the success of this new strategic compensation system.

Summary. Research Question II examines the design and operation of the strategic compensation system. This system is only five years old in Company A. The designers of the system worked in conjunction with executive officers to develop a plan which would help motivate employees to achieve corporate objectives.

The design and operation of the system requires that the Human Resource executives be apprised of corporate objectives and strategies. There is much information exchanged between the SCP and SMP -- during formulation, implementation, and control.

Each participant is informed of how their bonus will be calculated, and what minimum performance must be reached to earn a bonus. This takes the form of a written contract.

Although Company A has a very operable system in place, there is no way to handle problems and complaints in a formal manner. Currently, these are dealt with on an individual basis.

Summary and Conclusions

Although Company A is currently a subsidiary of a major bank holding company, the initial research conducted in Company A was done prior to the formal takeover. Prior to 1982, the firm was a federally-chartered bank that had a strong presence in its immediate geographic area, and had been involved in international loan activity. Due to volatility in the external environment, strategy and structure changes occurred in 1982. The new divisional structure provided a framework in which the compensation system could operate with more objectivity and direct responsibility for divisional performance.

Company A has about ten years of strategic planning experience. Similar to many other firms, the first attempts at planning met with limited success. Due to the efforts of top management, the firm currently utilizes strategic management. Additionally, top management believed in the power of incentives to motivate executives and managers to achieve corporate objectives. Because of this belief, the Human Resources Department was charged with the task of developing an incentive plan which covered most of its managers. Two plans operate concurrently -- one for upper management (MIP) and one for middle- and some lower-level managers (CCP). The MIP plan for upper management has both a long-term and short-term

component. Only top executives are eligible for the long-term incentive bonus.

Overall, the plan sought to encourage both teamwork and individual effort. Teamwork was encouraged by making some of the bonus depend on the performance of the corporation, the division, and the department. The remainder of the bonus was determined by an individual's performance as compared to previously established objectives. Individual objectives are jointly determined by superior and subordinate.

The strategic compensation plan of Company A was unique because of the attempts to reach down into the management ranks as far as possible. Because participants are made aware of their contributions to strategy, they understand what they are doing and why. This communication was thought to enhance performance.

Because the incentive plan was relatively new, some implementation problems were expected. However, no formal mechanism to handle problems existed at the time the research was conducted. Just as strategic planning evolved in Company A, it was thought by management that the strategic compensation system would go through a similar process.

Overall, Company A was a firm utilizing strategic management while trying to enhance their competitive position through the design and implementation of a strategic compensation system.

CHAPTER 6

RESULTS OF THE STUDY: CASE STUDY B

Company B was a community bank with a history of being both conservative and prudent. Ahead of its time, Company B had a long-term component to its incentive plan when the firm was privately held.

Analysis of Case Study B

This analysis is comprised of the following sections: data collection, background information, strategic management history, and strategic compensation history. Following the analysis are answers to the research questions and propositions.

Data Collection.

The data collection procedure consisted largely of interviewing and the utilization of other sources of information. On an average, interviews conducted lasted one hour. The topics discussed were decided by the position of the individual being interviewed. In Company B, interviews were held with:

(a) the President and CEO,

(b) the Executive Vice President of Corporation Planning and Finance Group,

(c) a Bank Branch Manager, and

(d) an Outsider who had knowledge of the company.

In addition to these sources, documents provided by the President and newspaper and magazine articles were other sources utilized.

Background Information.

Company B has been in operation for about 150 years. During this time, the primary market segment has been relatively small and well defined. Because of the structure of this firm during most of those 150 years, Company B could be aptly described as a community bank.

Since this firm had a legal status known as a state-chartered mutual bank, the law did not require management to disclose information concerning the financial status of the firm to the general public. Understandably, Company B developed the cultural norm of being a private firm. That is, the tendency to regard information and data about the firm which is now public, as still private, was obvious to the researcher.

Although Company B has made some recent major legal changes in its structure, the firm has survived these changes relatively intact. In a move that is becoming commonplace in today's New England competitive situation, Company B has made the transition from a state-chartered to a federally-chartered firm. Once this was accomplished, the firm proceeded to change its ownership status and become a publicly-held corporation. According to the President and CEO, the purposes of this major

change were to allow the firm to remain competitive, to be well capitalized, and to be structured in such a way as to be able to attain the long-range goals of the firm.

Immediately prior to the initiation of the conversion plan, Company B began to expand its activities and therefore its services. Documentation of this expansion can be made through an examination of the changes in Company B's structure over a four-year period. The structure of the firm in early 1983 (see Figure 6.1) can be compared to the structure at year-end 1986 (see Figure 6.2).

In response to the changing legal and competitive nature of the industry, Company B has begun to venture out of its previously defined market. Prior to 1983, the majority of its business was conducted in the conventional market. In Table 6.1, there is evidence of a change in market (and strategy) which utilizes changed laws and recognizes changed competitive forces. Company B does not compete internationally and has declared no intention of doing so.

The effect of Company B's changes in strategy and structure has had a very positive effect on its financial status. Not only has the firm had an increase in assets over the past several years, it has also had a dramatic increase in net income. The percentage increase or decrease in assets can be seen in Figure 6.3, and the

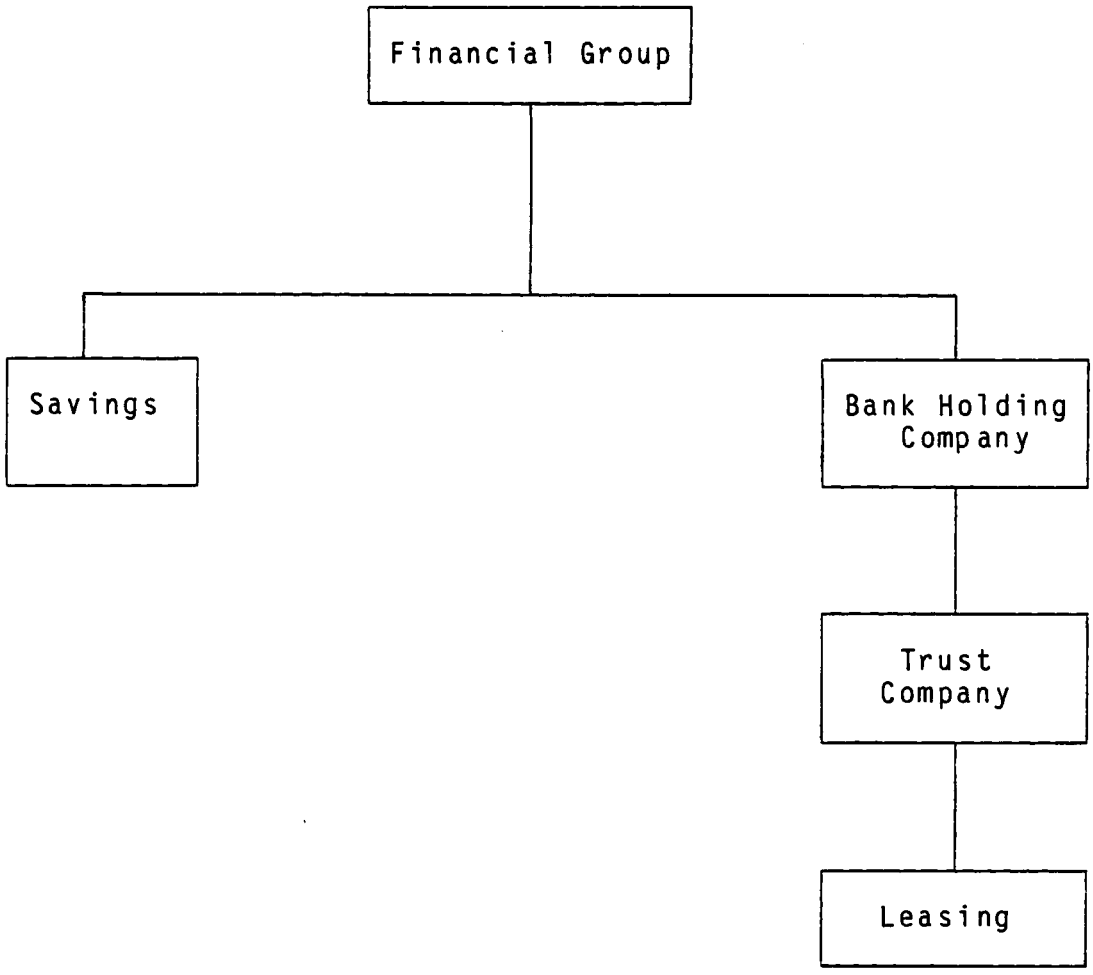


Figure 6.1. A Representation of the Structure of Company B in Early 1983, Showing the Limited Number of Subsidiaries Which Existed at That Time.

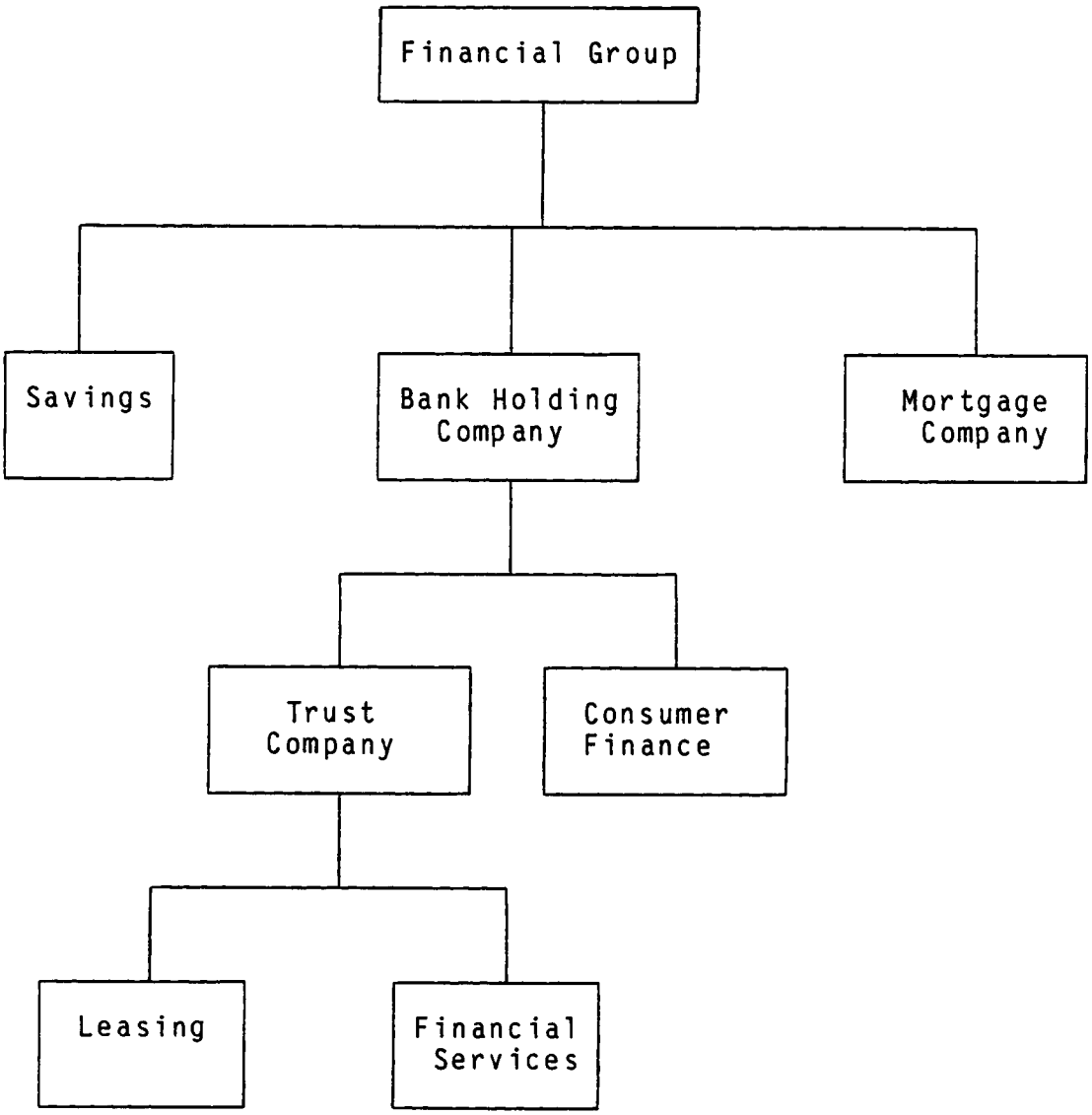


Figure 6.2. A Representation of the Structure of Company B at Year-End 1986, Showing an Increase in the Number of Subsidiaries and the Types of Businesses.

Table 6.1. How Company B Has Moved Into Other Markets.

Subsidiary	Date of Formation/ Association/ Acquisition	Primary Market
Trust	1800's *	Local
Savings	1800's *	Local
Leasing	1973	Local/ New England
Consumer Finance	1983	Outside New England
Financial Services	1984	New England
Mortgage Company	1986	Outside New England

*The exact dates are not given so as to preclude identification of the firm.

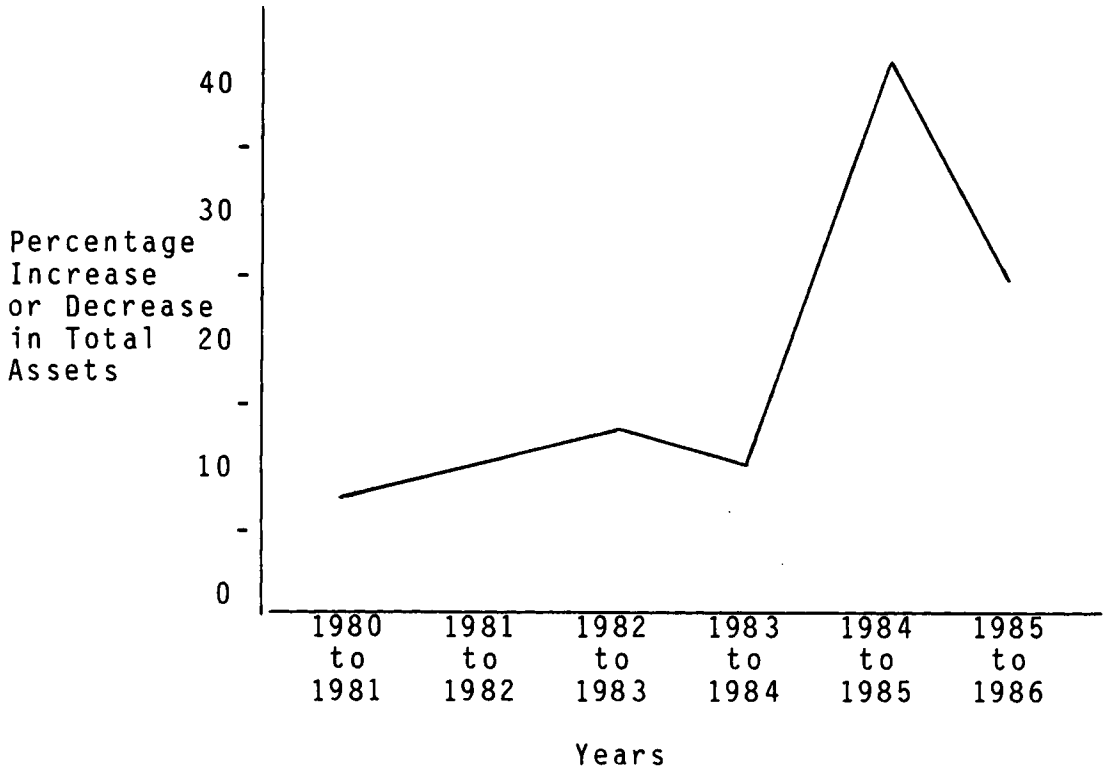


Figure 6.3. The Percentage Increase or Decrease in Total Assets From 1980 to 1986 in Company B.

percentage increase or decrease in net income can be seen in Figure 6.4.

In summary, Company B is a well established, well respected financial institution in its community. The most profound event in Company B's recent history is its alteration in legal structure. This alteration should allow the firm to take advantage of recent changes in banking law, primarily the deregulation of the industry, while at the same time recognizing that these laws have been the impetus to deal with the changing nature of present and future competition. The enormous task of changing its legal structure was a part of the firm's plans -- a strategic response to a changing environment.

Strategic Management History.

Although planning started in the early 1960's, there was no great effort to get a formal system in place. People in the firm were just starting to think in terms of planning. It was not very successful in these early years.

The first formalized attempts came about after the CEO attended a seminar and learned a basic approach to planning. In 1970, he/she organized a seminar and had the program brought back to the company. Professors from the Harvard Business School conducted the presentation to teach the executives how to plan. While the executives were presented with a program that could operationalize



Figure 6.4. The Percentage Increase or Decrease in Net Income From 1980 to 1986 in Company B.

planning, they decided not to initiate that particular program. Instead, they took the underpinnings of the program and tailored it for themselves.

The planning process which was devised and operationalized contained an MBO component. This is a significant fact in terms of the research being conducted because early in the planning history of the firm a link was established between achieving organizational objectives and incentives. However, the seminar did not guarantee the success they envisioned. Planning was found to be a great deal of work, and was considered very bothersome. Also, it was work that robbed executives of time they felt could be put to better use. The result was the plan was devised, but the attitude of some executives was that planning was not considered a top priority item. This attitude permeated the organization at first.

During the intervening years, the executives have had more success at planning. The CEO sees planning as vital to the success of the organization, and feels that they are currently sophisticated corporate planners. He/she recognized the fact that planning can become stale, and deliberately makes changes in the planning process to keep it from becoming a drudgery. Therefore, an attempt is made to find ways to introduce non-disruptive variety in the planning process. The CEO stated that no matter how

good you become at planning, people still regard it as taking time away from what is important right now.

While the CEO felt the firm was involved in sophisticated planning, others were less certain that the firm had reached that level of planning maturity. Specifically the Outsider interviewed felt that the conversion in legal status would have an extremely positive effect on planning, but that until that time the firm had not reached a level of sophistication attained in other banks. The Outsider did comment, that the bank was probably the best managed in its geographic area.

Company B has recently gone public after being privately held for over 100 years. Both the CEO and Executive Vice President of Planning felt that while planning was important before this transition, it is even more important now. The image of the company has been and still is one of deliberate, judicial, and prudent decision-makers and the officers want the public trust maintained. Because the company operates in a recently deregulated environment, planning has become necessary.

The Planning Process.

Consistent with the centralized decision making of the firm, the planning process is top down. Additionally, there is tremendous emphasis on control in this process. The control is evident in the meeting of objectives and in quarterly reviews with the Planning Committee of the Board

of Directors. While the CEO indicated that the timing of the planning cycle is sometimes altered (for the purpose of variety), the Vice President of Planning indicated that the company uses the following normal sequence of events in planning. The conversion from a private to a public company has disrupted the normal planning sequence, but this was a one-time event.

The cornerstone of the planning process is the mission statement. Company B stresses its cultural norm of integrity in the mission statement.

To begin, senior management meets to review long-term objectives and reaffirm or adjust goals for that year. The long-range plan is not done every year, but rather every three to five years. In other words, when the long-term plan has been established, updating occurs every year as necessary. However, top management does not intend to have the major thrust of the strategy drastically altered from year to year. Deregulation in the industry has cut the long-range goals and objectives down to three years as changes in the external environment make five year plans useless. In this meeting, senior management restructures and revamps the plan for the rest of the company.

Usually in February, an annual Managers' meeting is held. At this meeting the mission statement of the company is announced. Long-term goals for the different areas are also presented. The overall general strategies

for achieving these goals are discussed. Executive VP's recap the past year and discuss what they want done in the future. At this time major external variables are also discussed, including some more specific issues such as products, markets, and technological advances. This general meeting includes officers, managers, supervisors, and even manager trainees showing that the firm exposes all individuals with subordinates to the plans of the organization.

The executives devise two plans: a strategic long-range plan with long-range goals and strategies and a strategic action plan, covering the current planning year, with major objectives, goals, programs and processes. The senior officers group communicates the plans to all managers and group heads. Thereafter, group heads take the responsibility for reaching the specified objectives by devising plans consistent with the mission of the organization. In other words, the annual managers' meeting does not serve to set or communicate specific goals and objectives for individual departments. Specific goals and objectives are set later in the planning sequence.

The senior officers group meets quarterly with the Planning Committee of the Board of Directors. The emphasis here is on variances from stated objectives and

reasons for them are explored and discussed. This is another example of the emphasis on control in Company B.

In the fall, a two-day planning retreat is held for top management. Speakers are often brought in to instruct and answer questions. At this meeting a review of the results of the planning effort is conducted. The planning process is changed to make it more efficient and to provide a means for variety to be introduced. In addition to keeping the process itself viable, the executives deal with such topics as selection of markets, new product lines, and the development of technology.

The planning process and an approximate yearly schedule can be seen in Figure 6.5. The senior officers group has primary responsibility for the development and achievement of short-term and long-term objectives and strategies. Each group (division) is responsible for the achievement of certain objectives through a predetermined strategy decided by the executive group.

Additional objectives may be developed and monitored, after an individual prioritizes them. Certain lower level officers have MBO contracts. These contain specific objectives and performance steps. Each step has a timetable.

In summary, Company B has a well structured planning process which has been formalized since 1970. Although deregulation and going public have reinforced the need for

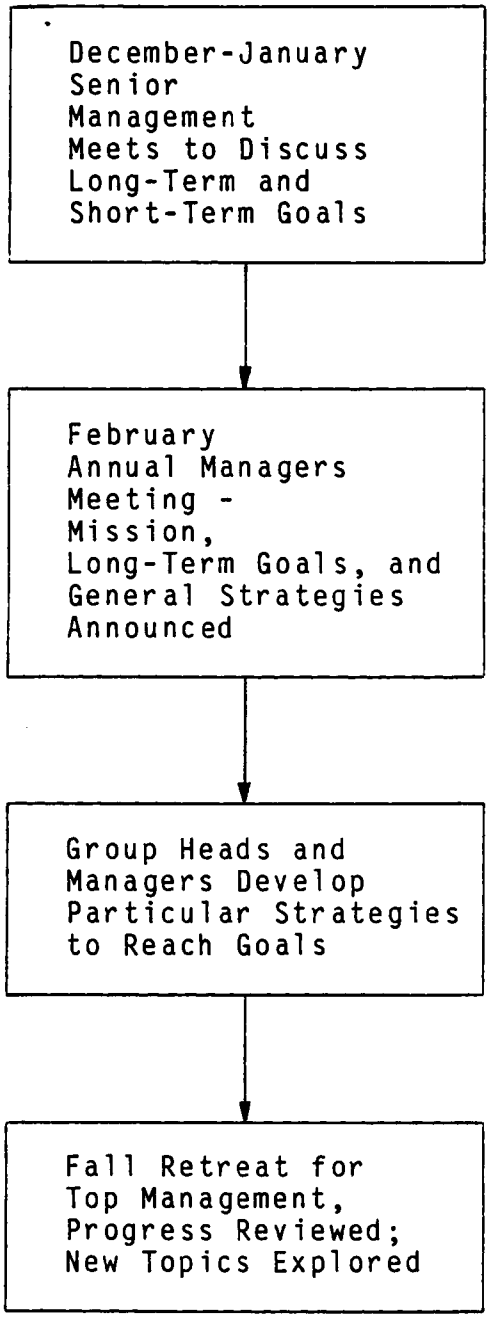


Figure 6.5. Major Events in the Planning Cycle of Company B, 1985-1986.

planning, officers are aware of the need to keep variety in the process itself. Traditionally, a strong centralized management has used the mission statement as the framework upon which the planning process has been built.

Strategic Compensation History.

As a private firm, Company B had utilized rewards for the achievement of both short-term and long-term objectives for a select group of top executives. There was in place a long-run incentive plan based on performance over three years. This plan had to be discontinued as the company began its conversion to a publicly-held firm. Because the plan needed to be approved at the first stockholders' meeting before taking effect, management had to wait until that time to reinstate a long-term incentive plan.

A new long-term incentive plan was needed, and criteria were established for the new plan. These criteria were: the long-range incentives had to relate to their long-term plans, the objectives had to be finite, and the incentives had to be financially related to the achievement of long-range goals.

The Compensation Committee of the Board of Directors is directly responsible for the compensation of the top officers of the company. This means that the Compensation

Committee devises the plan and renders judgment on the performance of these officers as stated in the plan.

Since there is an inherent risk of conflict of interest charges against the Compensation Committee, they have chosen to retain a professional consulting firm. Hopefully, this will provide an air of credibility and objectivity to the decisions of the Committee.

The compensation of executives below the level of senior management is determined by their superiors. Objectivity in these decisions is fostered through the employment of an MBO contract with prioritized objectives. The Bank Branch Manager confirmed that these MBO type contracts do not reach into the lower levels of the firm. He/she stated that such contracts would be welcome at lower levels as they would eliminate much ambiguity in terms of performance expectations.

The short-term performance-based component. The executive compensation plan has both short-term and long-term components. The short-term plan is called the Executive Performance Incentive Plan (EPIP) and all senior officers and eligible vice presidents participate. Company B has several kinds and levels of vice presidents, but inclusion in EIP indicates a position has significant bottom-line responsibility.

The awards are cash bonuses based on a certain percentage of salary. The percentage varies with the

position. There are four levels involved based on position and awards vary from 10 percent to 25 percent of base salaries. The sublevels are CEO, vice presidents, and senior vice presidents and other eligible vice presidents. There is also an (a) sublevel for individuals who are serving their first year in a position. This first year entitles a participant to a lower percentage than others in the group.

Goals that are established for these cash awards are financial goals related to companies in a peer group agreed upon by the Compensation Committee.

Specifically, a fund is established in February for incentive awards to be made. The fund has two parts. Part I, which contains two-thirds of the fund, utilizes three measurements or standards. Part II, which contains one-third of the fund, is individually determined by the performance against standards mutually established by the CEO and the individual.

Part I of the fund utilizes three standards, which have been predetermined through agreement with the Compensation Committee. There is a threshold figure for the predetermined profit standard which must be met. If the threshold predetermined profit standard is not met, then no one receives an incentive bonus. It is this threshold figure that is believed to be the key to keep

the team working together. Return on assets is used to determine the profit standard.

In addition to the profit standard, there is a growth and quality standard. Asset quality, delinquencies, share of the market, and certain ratios are examples of measures used by the Compensation Committee to judge progress in the area of growth and quality. There is also a positioning standard which is about ten percent of the fund. This standard is judged by the extent of the completion of the CEO's operating plans for the year.

The long-term performance-based component. This component of the plan is included in the Stock Option and Performance Share Plan. The long-term plan replaces the old three year bonus plan, but the intended results are hoped to be the same. The purpose of the plan is to encourage long-term commitment to the organization. This commitment is thought to foster a continued concern for the long-term interests of the stockholder and the company.

Those who are included in this plan are charged with the successful creation of value for the shareholder as reflected in earnings per share (EPS). The long-term plan is to increase EPS as it relates to the original base. There is also concern for an increase in the fair market value (FMV) of the stock. A final area deals with judgments about the quality of management.

The participants in this plan are eight executive officers, a much smaller group than executive performance incentive plan. Performance objectives established over the long-term are based on achievements over a thirty month period.

This portion of the plan is consistent with the thinking of the organization -- consistent performance over the long-term.

Research Questions and Propositions

Research Question I.

The major area of concern in Research Question I is the determination of the external and internal factors considered in strategic compensation and how changes in these factors are handled.

Proposition I.1. Proposition 1 is specifically concerned with the identification of external variables, and proposes that industry, compensation systems of competitors in the same industry, and economic conditions, particularly inflation and tax laws are the external variables which shape executive compensation.

Because of the concern for possible conflict of interest charges against Compensation Committee members, an outside consulting firm is retained to advise these board members on the appropriateness of compensation decisions. This is in keeping with Company B's desire to

maintain their public image as an honest institution. Some of the information used in determining important variables comes from the consulting firm. However, both the board members and the executive officers are well aware of the variables entering into the determination of corporate objectives. The attainment of these corporate objectives determines their incentives, both short-term and long-term.

The industry is the most important variable at this time. Deregulation of the industry has prompted the alteration of the company's structure, causing it to go public. Company B had long been known for serving primarily its specific target, which was relatively small in geographic area. In anticipation of changes forthcoming due to deregulation, going public provided a means to respond to new profitable opportunities and to get an infusion of capital enabling them to respond in a timely manner without the extra burden of finding the capital to do so.

Industry plays a dual role in its affect on the executive compensation system. First, because of deregulation, the industry environment is considered volatile. Since volatility means a constant re-evaluation of conditions, changes in the industry have a large impact on goal setting. Second, the industry also provides a general framework for base salary levels and

the types and levels of non-base remuneration. When establishing goals, both corporate and individual, changes in industry are very carefully considered.

The retained consulting firm does the necessary research concerning compensation of competitors in the same industry. Although attitude of Company B is one of wanting to retain top employees, the integrity issue enters in here as an extra criterion. Most certainly the firm wants to be competitive, but also wants a certain type of employee.

Historically, the company has monitored economic conditions very closely. Both inflation and tax laws have played a large part in determining corporate goals and objectives in both the short-term and the long-term. Cost of capital has also been very important. Tax laws are a major consideration in determining the form of executive compensation, and directly impact the executive compensation. Inflation is used to determine cost-of-living raises in base salary, but at this present time, is not a problem.

The firm uses an outside company to assist in identifying important variables. This information is usually presented at the retreat for executives in the fall.

Executive officers also are responsible for monitoring these variables. The Planning Committee of the

Board of Directors is given this information as well. In determining appropriate performance goals for eligible top executives, the Compensation Committee receives information from the Planning Committee and the outside consultants (see Table 6.2 for a summary of external variables).

Proposition I.2. Internal variables are an integral part of setting goals. Size of the firm is very clearly a major component. The Vice President of Corporate Planning stated that their performance is judged by how well they do in comparison with peers of similar size. The EPIP's profit standard is determined using companies of similar size.

In this company, the strategy and structure play a role in determining executive compensation. Goals established for the company are the goals of the CEO, and the goals of the other executive officers closely reflect these. Division heads are given profit responsibility; therefore, structure also aids in pinpointing responsibility. Certain more distant ventures (those physically removed from this geographic region) are judged on predetermined standards as well. Culture plays an important role in determining performance. Stressed above all is integrity. Ethical behavior is expected within and without the confines of the company. In determining what

Table 6.2. External Variables That Affect the Design and Administration of Company B's Executive Compensation Plan, 1985-1986.

Variable	Comments
* Industry	· extremely important variable
* Competitiveness	· important · wants to retain top performers · wants people of high integrity to be consistent with mission
* Economic Conditions * inflation * tax laws cost of capital	· historically has always monitored these very closely
Public Opinion	· the Compensation Committee of the Board hires a consulting firm to maintain objectivity with regard to executive compensation

*Variables predicted and supported by the literature.

goals are to be established and how awards are to be given, integrity is expected.

Financial constraints were not mentioned as a variable in determining executive compensation. Perhaps the large infusion of capital from the sale of stock has, for the time being, alleviated the pressure of financial constraints.

A summary of important internal variables and their affect on Company B's executive compensation plan is on the following page (see Table 6.3).

Proposition I.3. For external variables, forecasting is done by a consulting group. A five year forecast is done, but the company utilizes shorter-term forecasts for establishing goals and objectives. Some forecasting is also done by different divisions, but it appears that the outside consultant is the primary source.

The primary concern of Proposition I.3 is the forecasting of external variables which affect the executive compensation system.

While the fact that external variables for the SMP are monitored and forecasted has been established, the specific external variables which affect the executive compensation system are treated somewhat differently. Since the officers interviewed at Company B have shown concern over their image in general, and their objectivity regarding executive compensation in particular, most of

Table 6.3. Internal Variables That Affect the Design and Administration of Company B's Executive Compensation Plan, 1985-1986.

Variable	Comments
* Size of the Firm	· a direct correlation
* Strategy and Structure	· structure aids in pinpointing responsibility for achieving goals
* Culture	· the goals set and strategies developed to achieve these goals must be consistent with the firm's norms of high integrity

*Variables predicted and supported by the literature.

forecasting is done by the consultants for the Compensation Committee of the Board of Directors.

This does not mean, that the Compensation Committee does not also gather or consider other data which may have been collected by officers and/or division heads. Forecasting is done on a three-year basis for the long-term component of the executive compensation plan.

Indirectly, the forecasts for the company also play a big role in forecasting for executive compensation. If the goals of the company are the goals of the CEO as was mentioned by the Executive Vice-President of Planning then it follows that the CEO helps set company goals, and hence, his own. Of course, the overall strategic direction and goals of the company are set by the Planning Committee of the Board of Directors, and this helps to add credibility as well.

Proposition I.4. Strategic planning has developed to the point that some firms monitor crucial external factors continuously, and will adjust corporate or divisional objectives if the changes are severe enough. Carrying that idea to compensation would mean it is feasible to alter corporate executives' goals if severe changes warranted it. This proved to be untrue in Company B.

Major changes in variables cannot be accommodated by the present system. When annual goals are established, they can't be changed. There is some leeway in that about

ten percent of the fund for the EPIP is based on the substantial completion of the CEO's operating plans, but there still is a profit threshold which must be met. There is far less room for adjustment now that the company has gone public because the firm is legally bound to adhere to the plan as presented to and approved by the stockholders.

Summary. In summary, the first research question may be answered by saying:

(a) The primary internal variables are size, culture, and strategy and structure.

(b) The primary external variables importance are the industry, compensation systems of competitors, and economic conditions, particularly inflation and tax laws.

(c) Forecasting is done primarily by an outside firm and executive officers.

(d) Changes in major variables cannot be accommodated in the compensation system as it now stands.

Research Question II.

The second research question focused on the design and operation of the strategic compensation system. Of concern is how the system is designed and operated within Company B.

Proposition II.1. This proposition asserts that designers of the executive compensation system are knowledgeable about corporate objectives and strategies designated to achieve them. This is essentially true for Company B. The Compensation Committee is responsible for handling the design and administration of Company B. Since the Compensation Committee has a legal responsibility to the stockholder, a consulting firm is retained to aid them in the design and administration of the executive compensation system. The Vice President of Planning pointed out that the consulting firm is there to advise the Compensation Committee, not run it.

This information is used to help construct the short-term and long-term goals for executives. The Planning Committee also provides them with information.

History also enters into play as well. The company has an image of steady growth which it wants to maintain. Investors, the community-at-large, and officers and board members all know this. There is not much room for maneuvering.

Proposition II.2. In Proposition II.2, the existence of points of information exchange between the strategic management process and the strategic compensation process are postulated. There are several such points in Company B. Starting with the Board of Directors, the Planning Committee and the Compensation Committee must exchange

information in order for top executive performance goals to be established. Quarterly meetings between the Planning Committee and executive officers serve to provide an evaluation of progress towards goals (see Figure 6.6 for a diagram of the information exchange).

The control system operates as a point of information exchange, too. Each officer's goals, action plans for reaching these goals, and timetable for reaching these goals are clearly spelled out. While some divisions are physically removed, most are not. As previously mentioned, Company B is a centralized firm, and the proximity of the officers group makes it very easy for interim progress to be evaluated -- and it is, both formally and informally. Ultimately, the executive officers must account to the Board, and their subordinates must account to the executive officers.

Proposition II.3. The above paragraph actually addresses Proposition II.3 which asserts that executives are made aware of corporate objectives and their own performance objectives, and that these executives know how they will be evaluated as to their performance. This is certainly true for Company B.

For third tier executives, an MBO contract is used. This specifies actual goals, performance steps and timetables for achieving these goals.

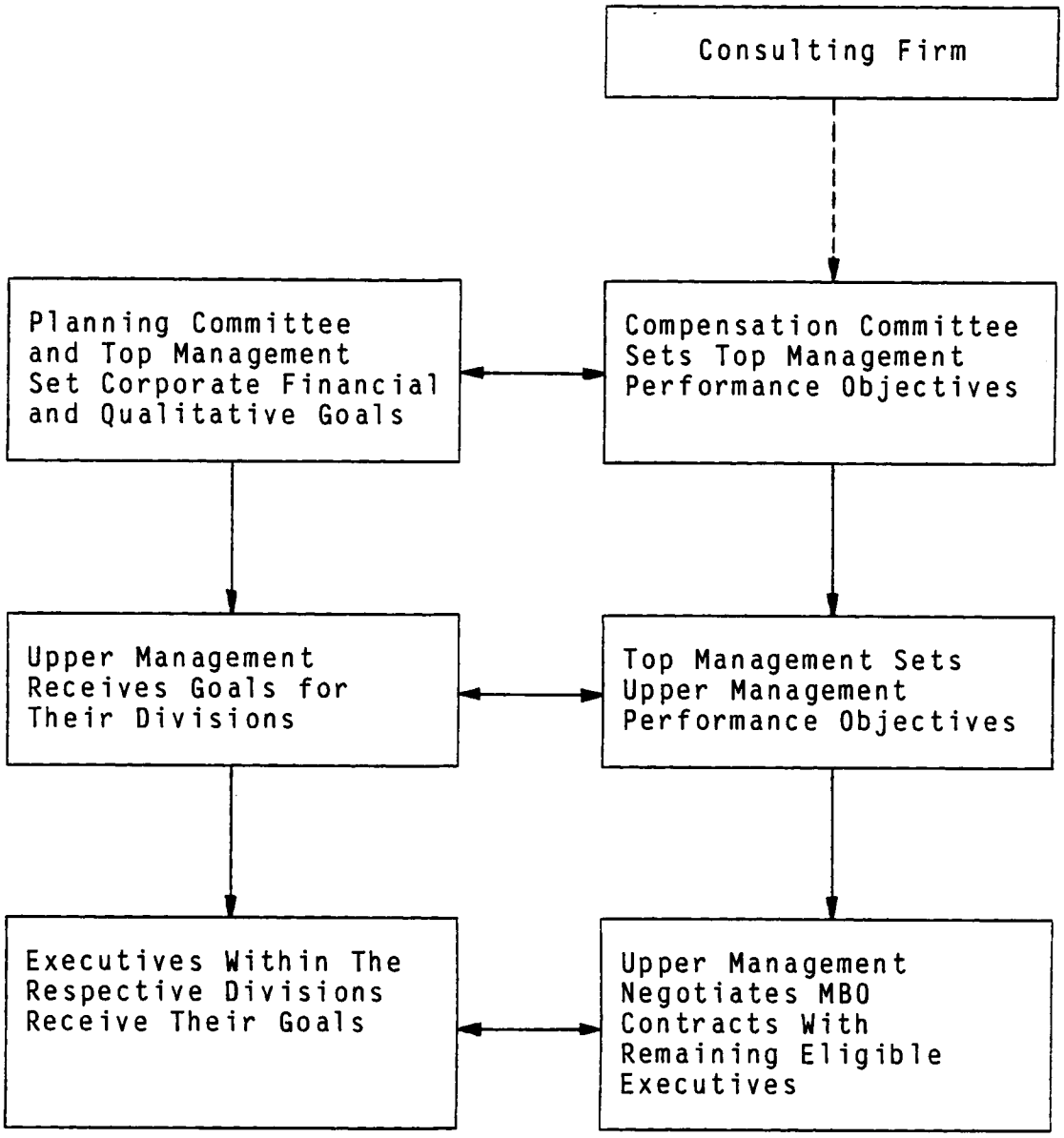


Figure 6.6. Information Exchange Between the SMP and SCP in the Formulation Stage in Company B, 1985-1986.

For all executives participating in the executive compensation plan, knowledge of corporate objectives, their performance objectives, and how they will be evaluated is made clear.

Proposition II.4. The existence of a formal mechanism for evaluating problems in the system is postulated. In Company B's case, this is questionable. First, this plan was just formalized as of June, 1985 through shareholder approval. Second, although not explicitly stated, the company has used a similar plan for a number of years prior to going public. The major change is the Performance Share Plan, which replaces the long-term bonus. On the one hand, they are locked in by the recent shareholder approval, and on the other hand, they have had enough experience with a similar plan to know the one they proposed will work. No formally declared mechanism is acknowledged to handle problems.

Since the Board of Directors is ultimately responsible for the proper operation of the plan, they did provide for a way to alter the plan somewhat without shareholder approval. Legally, though, material changes in the plan require shareholder approval.

Summary and Conclusions

Company B has had a long history of being a well-run, well-respected, albeit conservative, community bank.

Although bound by its roots to the geographic area it originally served, the firm has been growing and changing its strategy in response to an altered external environment.

Although Company B had halting progress when planning was initiated in the 1960s, it was now an experienced planner. Perhaps the major event in its recent history, that of becoming a publicly-held firm, has raised the value of planning. Certainly no indication ws given that planning activities will be lessened.

Even before Company B became publicly-owned, a long-term incentive plan existed. The conversion period forced the plan to be temporarily dropped, but has since been revived with stockholder approval. The officers have no doubt about the value of such a plan because they have had years of experience with an incentive plan. In their opinion, the use of long-term and short-term incentives leads to consistent growth and probability over time -- a sure measure of success.

Company B's culture was a dominant force in the strategic management process and the strategic compensation process. Known throughout its market as an institution with a concern for integrity and prudent management, upper management was highly centralized. There was a great deal of both formal and informal communication concerning progress towards corporate and

executive goals. Additionally goal achievement through and consistent with the chosen strategy was important.

Similar to Company A, however, was the utilization of a growth strategy with a move towards increasing use of divisional structure. Upper management essentially decided the goals of the corporation, and divisional and departmental goals were subsets of the corporate goals. Likewise, top management goals were the goals of the corporation, and subordinates' goals. The Executive Incentive Plan has a long-term component for a few eligible executives and a short-term component for a larger number of executives.

Since Company B's plan has been in operation for several years, it would seem likely that a formal mechanism would have evolved to handle problems which might occur. However, that mechanism could not be identified, and further growth and decentralization may cause problems in the current system.

CHAPTER 7

RESULTS OF THE STUDY: CASE STUDY C

While Companies A and B initiated strategic management through several attempts, Company C has utilized the process continuously since its inception. The continuous support of the strategic management process by top management has resulted in a planning culture. Recently, a strategic compensation process has also developed, along with several incentive programs that affect even the lowest level employee in the firm.

Analysis of Case Study C

This analysis is comprised of the following sections: data collection, background information, strategic management history, and strategic compensation history. Following the analysis are the answers to the research questions and propositions.

Data Collection.

The data collection procedure consisted largely of interviewing and the utilization of documents provided by Company C. On an average, interviews lasted forty-five minutes. The topics discussed were decided by the position of the individual being interviewed. In Company C, interviews were held with:

(a) Vice President and Vice Chairman of the Board,

(b) Chairman of the Board and CEO,

(c) Vice President and Group Executive,

(d) Senior Vice President of Personnel, and

(e) the Corporate Planner.

Prior to the interviews, copies of the last annual report and a proxy statement were sent to the researcher. Additional sources were provided at the site.

Background Information.

Company C changed from a federally-chartered bank to a state-chartered bank and trust company in 1977. As it existed in 1977, the bank was a consolidation of two community banks. Today commercial banking is its primary interest.

The main events in Company C have emanated from changes in strategy which have occurred. Just like many other banks, this firm has begun to move tentatively outside of its main sphere of influence. Although the firm has a very strong presence in the state in which it is located, deregulation has prompted management to move outside its normal business boundaries.

The structure of Company C prior to 1985 can be seen in Figure 7.1. Currently there is a parent company which owns the state bank and trust and a new subsidiary engaged in small business financing, as can be seen in Figure 7.2.

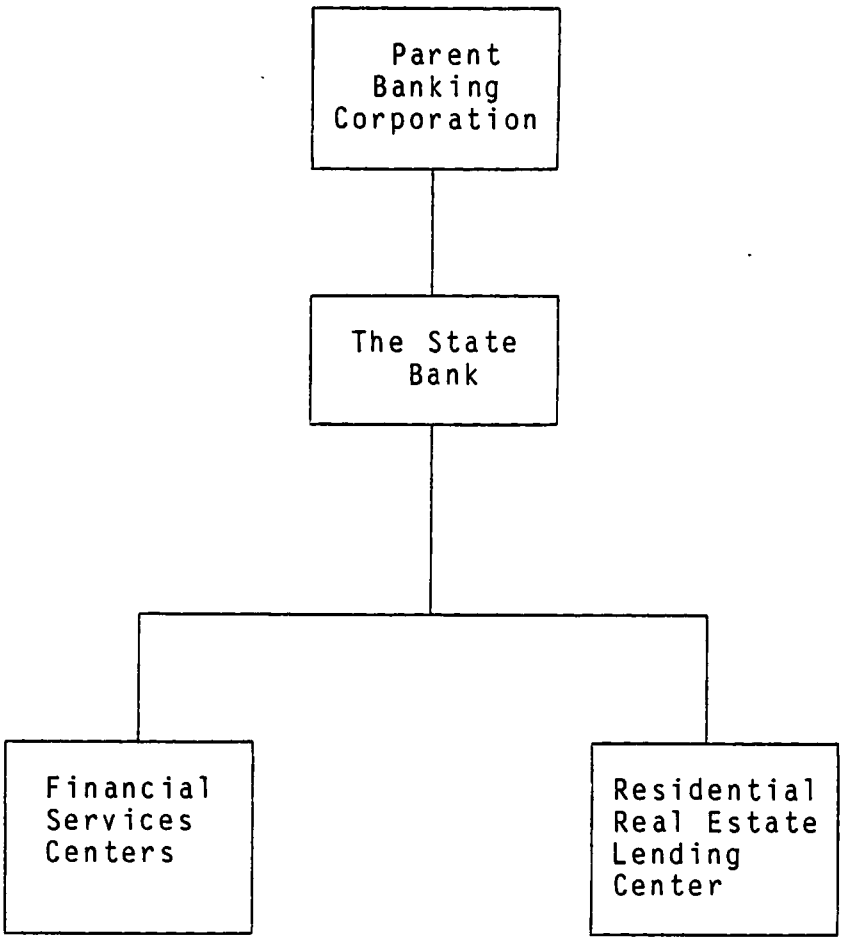


Figure 7.1. The Structure of Company C Prior to 1985.

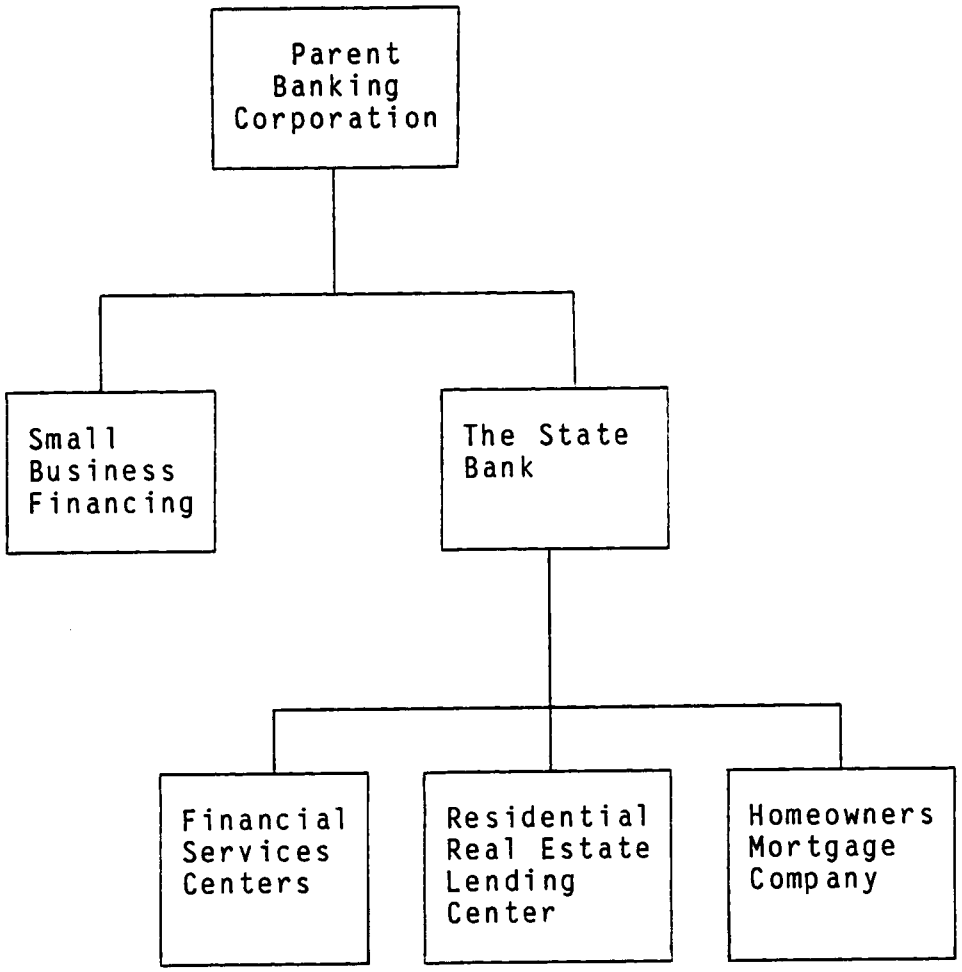


Figure 7.2. The Structure of Company C in 1985 Showing an Increase in the Number of Subsidiaries.

Geographically, the company has grown slowly and deliberately. Since the bank regards their home state as their primary market, growth has occurred within the state. The Financial Centers have moved into several additional cities in-state and into two distinct markets in a contiguous state. The Bank increased the number of branches throughout the state during 1985 as well.

Financially, Company C is in excellent condition. The percentage increase in average total assets from 1981 to 1985 can be seen in Figure 7.3. The percentage increase or decrease in net income from 1981 to 1985 can be seen in Figure 7.4.

In terms of strategy, Company C could be described as prudent and thoughtful. Not known for taking foolish risks, out-of-state expansion started with one office, then two, then three -- each opened in a different year. In-state the firm has been more aggressive, with businesses being opened in the high growth areas of the state. Product development has also been successfully used.

Company C is a growth oriented company tempered by prudence. While known in their home town, they are spreading out to other areas in banking and in related businesses.

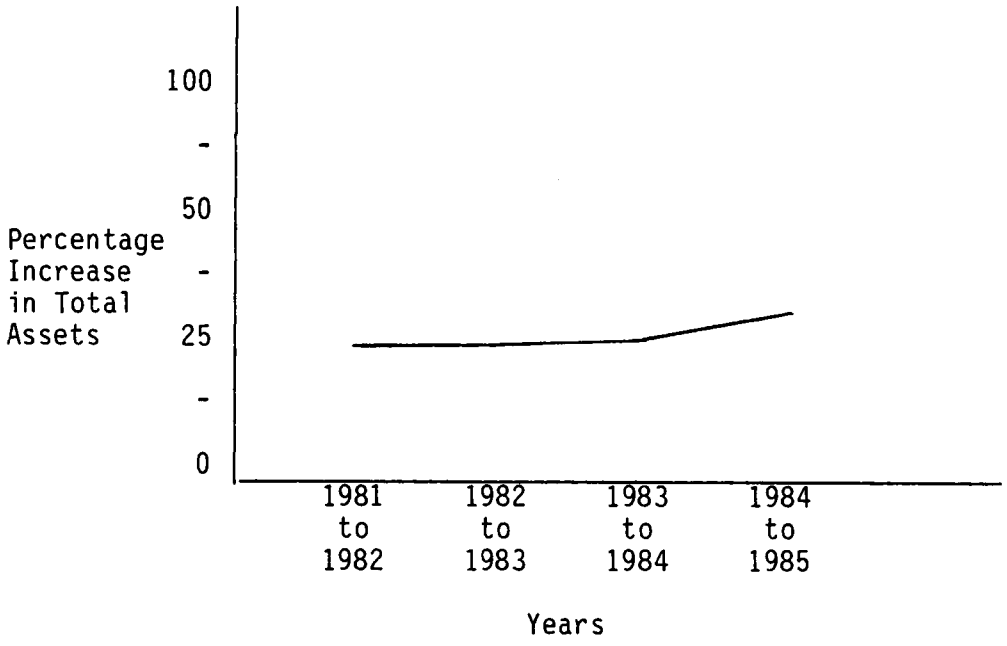


Figure 7.3. The Percentage Increase in Average Total Assets in Company C From 1981 to 1985.

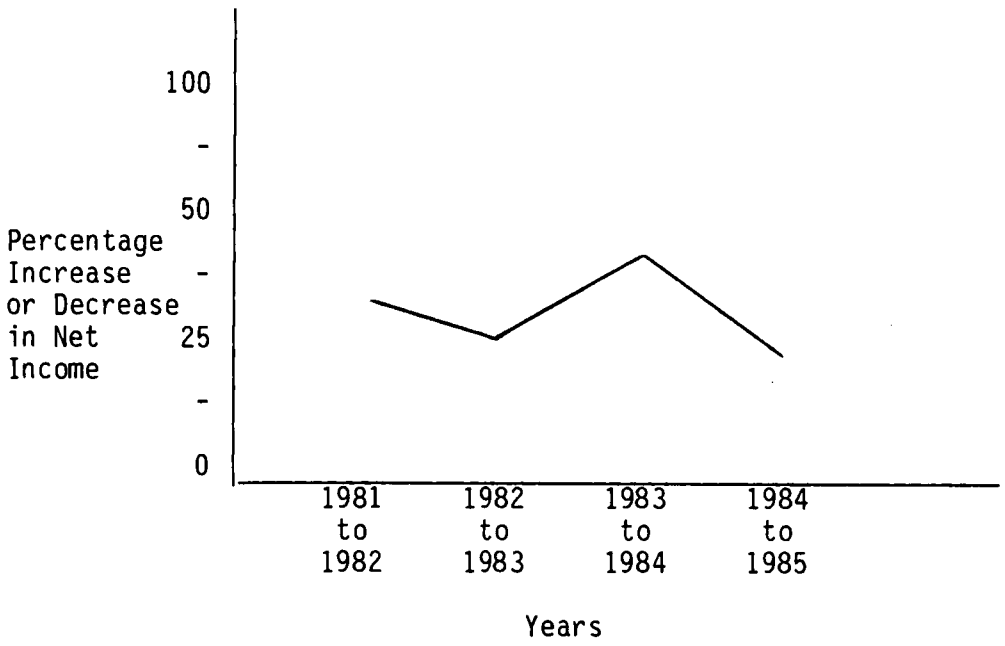


Figure 7.4. The Percentage Increase or Decrease in Net Income in Company C From 1981 to 1985.

Strategic Management History.

The history of strategic planning at Company C started as a result of a financial loss. Faced with providing the Board of Directors with a solution to the situation, the top two corporate officers decided to institute strategic planning. In Fall, 1976, seven individuals, with various areas of expertise, were chosen to be part of the first strategic planning effort. These individuals were charged with initiating planning throughout the entire company.

The structure of the firm at that time was a holding company with a dominant product subsidiary. There were also two ancillary businesses -- one in real estate and one in leasing -- but these were disposed of at about the same time that the planning effort was started. In fact, these two businesses were partially responsible for the poor financial performance of the company and the initiation of strategic planning.

Perhaps because the start-up of strategic management came as a result of an executive officer directive, there has been continuous, strong upper level management support for the planning effort from the beginning. In Fall, 1976, the first planning attempt was made. The Group Executive interviewed was a member of the first planning group, and described the effort as whole-hearted, but far

less sophisticated than the planning done today. The emphasis was on budgeting, but no attempt was made to establish a mission, goals, and strategies.

Environmental analysis was conducted during the first year. It was a cursory and preliminary effort, but each of the seven individuals on the planning committee had a special area of expertise. The reason for external analysis was to add credibility to the presentation of the strategic planning effort to be made to the Board of Directors. While the content in 1976 was based mostly on the general economic environment, the content for 1977 included other segments in the external environment such as competitive analysis.

In the years 1977-79, a more definite process was developed. Mission, goals, and strategies at the corporate level were developed by senior management. At an August, 1979, Strategic Planning Conference, the mission, goals, and strategies were presented to upper management. Upper management was then responsible for developing consistent goals, plans, and budgets for their particular departments. By the company's standards of today, those first strategies were very tactical and short-term. However, a definite commitment to the continuation of strategic planning was established. Therefore during 1977-1979, there was movement to improve

continually and upgrade the quality of planning. Although there was some resistance to the initiation of planning existed, that resistence was confined to the traditionally conservative strongholds in the company. In fact, the same unit in Company A as in Company C resisted the institution of planning.

During the years 1980 through 1982, a change in top management occurred. Those who are running the company today moved up into their current positions at that time. These top officers have a strong commitment to strategic planning and believe it is responsible for the turnaround of the company.

Initially, the planning cycle consisted of gearing up for the Strategic Planning Conference. "Gearing up" was the preparatory stage where the actual planning was done. In this stage, the executives worked with the planning group. At the conference the plan for the year which had been developed was presented to top management. After the conference, departments wrote their plans and budgets. Meanwhile, those charged with the planning effort used the lull period after the conference to learn more about their responsibilities in the area of planning. This was done by reading journals and books about the subject (see Figure 7.5).

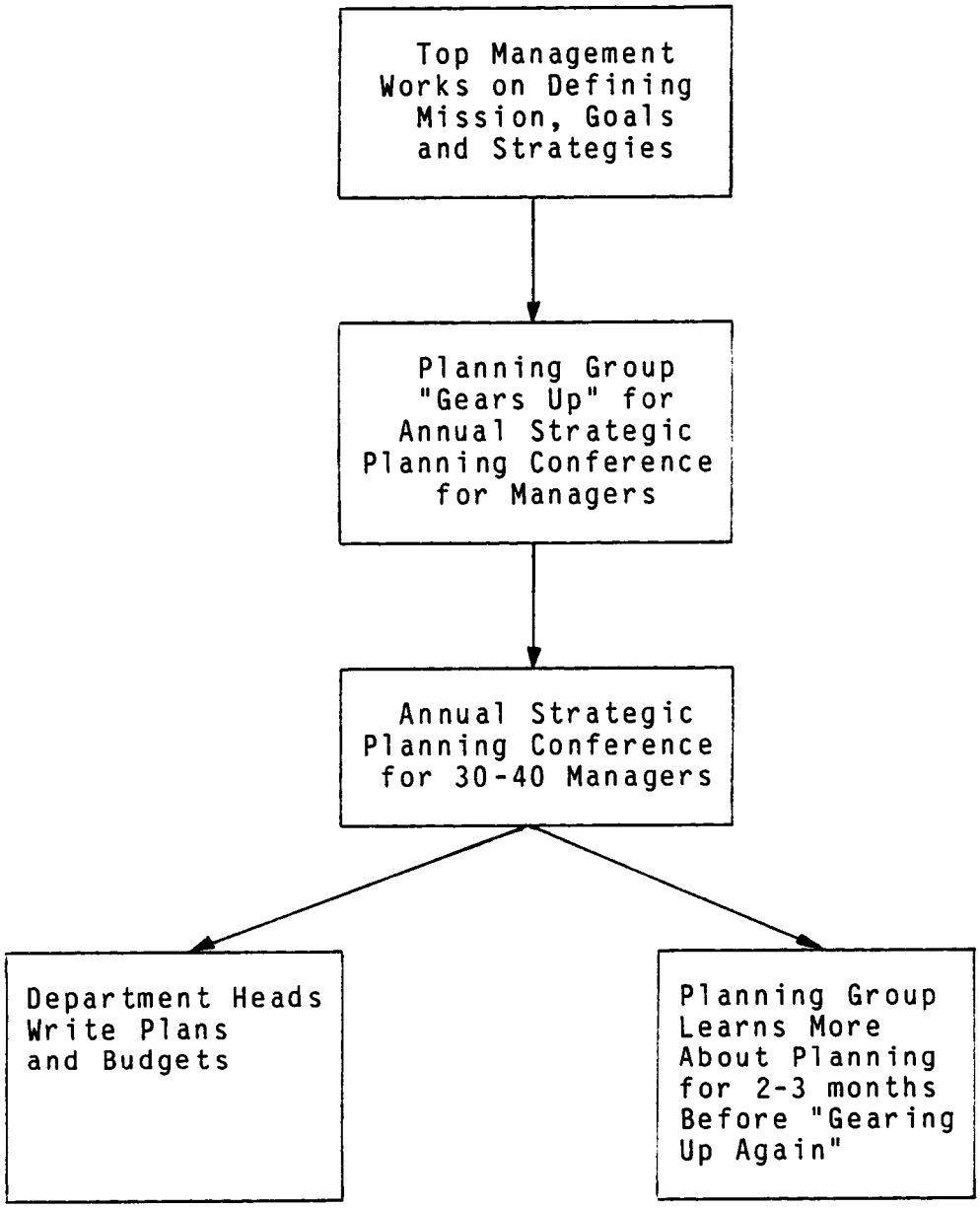


Figure 7.5. The Planning Process of Company C in the Early Years of Planning, 1977-1979.

The first conference included only 30-40 managers. Over the years, the number of managers attending the conference has steadily increased. This is a reflection of the company's continual effort to include more people in the strategic management of the firm. Currently, approximately 110 managers attend the Strategic Planning Conference.

The strategic planning efforts of the company have grown and become more sophisticated since its inception in 1976, as can be seen in the schematic of Company C's planning process which was provided by the firm (see Figure 7.6). The culture of the company today is considered a planning culture. One executive commented that the company is run by the Bible of Strategic Planning.

The planning effort is a co-ordinated effort between the top executives, the corporate planning office, and the top managers (who head the various departments). Currently, the planning office nominally operates under the marketing department, but the corporate planner actually reports to the CEO and top executives.

Although the highlight of the year is the three-day Annual Strategic Planning Conference held in August for the top 110 managers, the process is continuous through the year. During the conference, top management presents

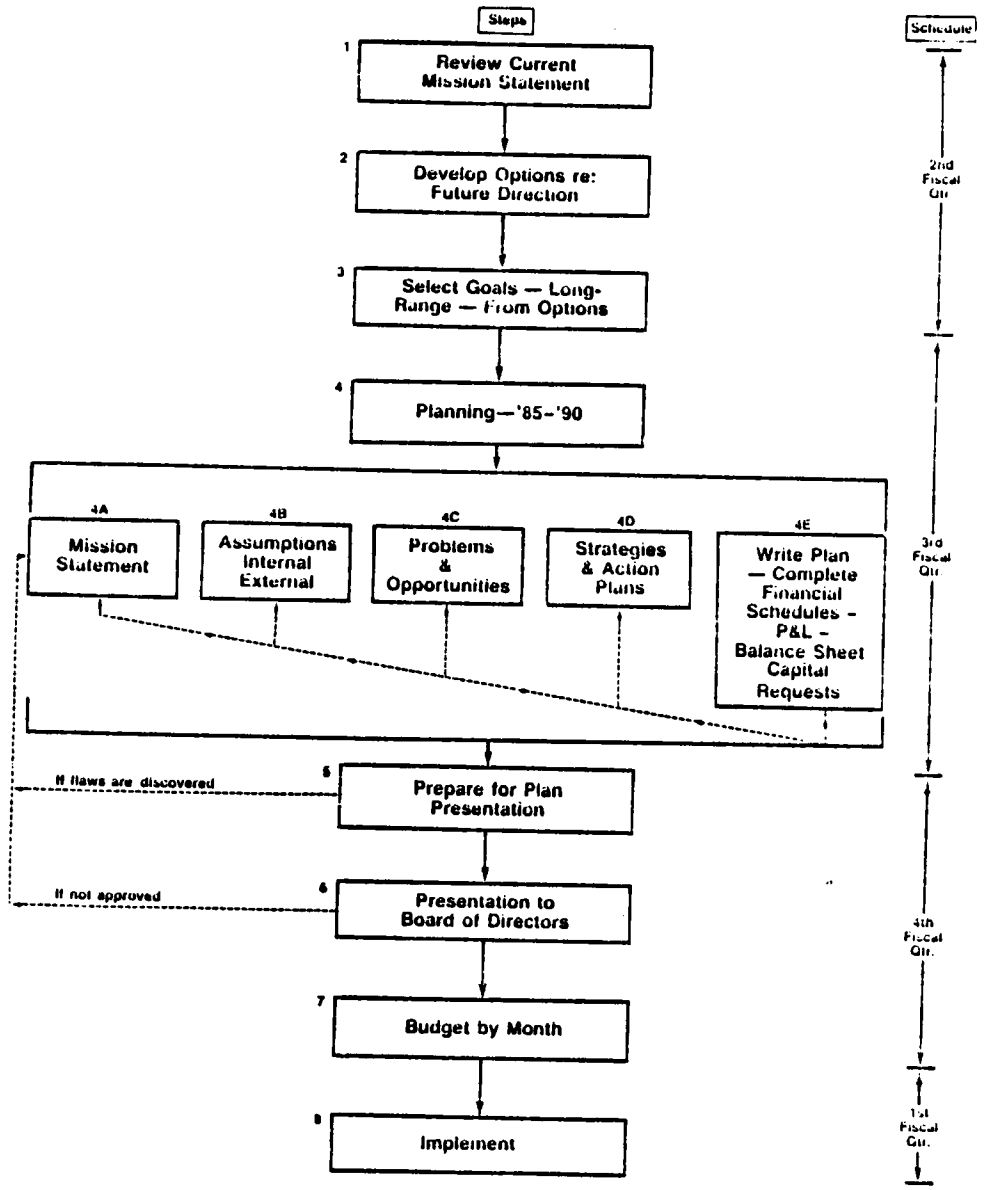


Figure 7.6. The Business Plan Schematic Currently Used by Company C to Guide The Sequence of Their Planning Process, 1986.

the mission, key strategic issues, major external environmental issues, and desired financial targets.

In preparation for the meeting, the corporate planner spends October through December identifying key issues to explore and integrating the possible effects of these issues into the operating plan and budget. Input from the twelve senior vice presidents is obtained during monthly planning meetings. The President concurrently spends time assessing the appropriateness of the mission, checking to see if it is consistent with the current situation in the external environment. The corporate planner has constant interaction with the President and senior vice presidents, and it is his/her responsibility to keep his/her ear to the ground for possible issues of importance and concern. January through June of the year are spent on analysis of information and issues.

This past year, the President decided to spend time on the appropriateness of the mission. He/she decided to work on the mission alone and then meet with the Senior Vice President and two consultants at a weekend retreat to get their input. It was not considered unusual in this company for the CEO to make major decisions alone. Historically, the company has operated with a top-down approach, but that has been changing over the last couple

of years. Currently there is an effort to encourage input from the bottom.

During September through November, departments develop their operating plans. By the end of October, the missions, goals, strategies, budgets (with priorities) and projects are supposed to be submitted to division heads. The goals that upper management imposes on the departments are usually quite ambitious, and this results in some negotiating on goals and projects. The department goals are fed into the computer to see if they approximate the corporate goals. Some adjustments must usually be made. The process is finalized in December when budget hearings are conducted.

Control is accomplished through quarterly reviews which were initiated in 1980. The quarterly reviews compare progress against the operating plan and the budget.

There is some flexibility built into the system. If a plan or goal is no longer feasible, then reprioritizing is done. Operating plans are considered as guides, not mandates written in stone, and are supposed to represent a best guess intended to recognize problems and opportunities. Contingency planning is not yet done.

Senior Vice Presidents vary in their focus with regard to planning. Some Senior Vice Presidents are more tactically, operationally oriented than others, but the

the President is definitely oriented towards the long-term. The industry has recently undergone deregulation, which has shortened the time frame for the development of useful long-term plans. The Planning Committee works about three years out in terms of corporate strategy and finance while the strategic thrust is conceptualized out about three-five years.

Company C has made a continuous, substantial effort to be proficient planners. Additionally, management realizes that there are constant changes and improvements being made.

Strategic Compensation History.

With regard to the organization wide use of incentives, there is a strong belief in incentives as a source of motivation. While executive compensation is based on incentives, several incentive programs are operating at one time -- and some are in areas where incentives traditionally are considered dangerous. For the firm, with its well established controls and frequent monitoring, these programs have worked for the company's benefit. For example, one of the specific programs is award of a share of stock for every three positive letters, phone calls, or comments made by customers about employees in direct contact with customers. Another is the ability of executives to give incentives to

subordinates throughout the company as he/she sees fit. Clearly, upper management believes in management by incentive.

At the executive level, there are several forms of incentives, some short-term and some long-term. Base pay for top managers is higher than the average for comparable institutions. This is a deliberate attempt to attract and retain above average top management. The Personnel Committee is responsible for this decision. The base salary range is determined by the salaries paid to like executives of the top performers in the industry in the country as determined by such measures as return on equity and return on assets. Company C utilizes the midpoints of the salary ranges and adds 15 percent for top officers except the President, who receives an additional 25 percent.

The top 50 jobs qualify for an annual incentive bonus which is paid in cash. The payment of this bonus is dependent upon the degree of completion of the five or six goals set for the year. These goals are derived from the description established for that particular job. The job descriptions are written in task format. These tasks are then translated to goals.

Agreements about what the goals should be is a limited, tentative process. It is limited in the sense

that management pushes for ambitious, but achievable goals. Both superior and subordinate must review and agree to the goals which are set, and sign a form indicating this has been done. Goal levels established are based on the content of the strategic plan for the year. The Vice President of Human Resources allowed the researcher to examine an anonymous but completed appraisal form. The goals set were specific, and largely measurable by quantitative means. Accomplishment is formally judged or stated in quantitative terms also. Bonuses are determined by the overall level of accomplishment.

Long-term goal achievement is based on stock options. Only the top 22 jobs participate in this plan. The payout is based on a comparison of actual stock appreciation with targeted appreciation over the next five years. The figure is calculated as a multiple of base salary. The multiple is higher at higher levels of responsibility and then moves down. The vesting schedule is 25 percent at the end of every year from the second year to the fifth year.

Appraisal of performance is reviewed by the Personnel Committee of the Board. The performance of all of the top 50 officers is reviewed, but top positions are much more closely scrutinized. Goals of officers at or near the top

are highly reflective of the goals set for the organization.

In terms of attitude towards incentives, this company and its Board of Directors believe in and support incentives. There are 17 incentive plans in operation throughout the company, and the company budgets two million dollars out of 30 million for support of these programs (see page 228 for two examples of such plans). Ultimately, for officers at some time in the future, base salary will make up only 50 percent of compensation, while the other 50 percent will come from bonuses and long-term incentives.

Research Questions and Propositions

Research Question I.

The major area of concern in Research Question I is the determination of the external and internal factors considered in strategic compensation, and how changes in these factors are handled.

Proposition I.1. Proposition I.1 is specifically concerned with the identification of external variables, and proposes that industry, compensation systems of competitors in the same industry, and economic conditions, particularly inflation and tax laws are the external variables which shape executive compensation.

In Company C, a situation exists which is caused by the structure of the firm. The Human Resource Department monitors certain variables which affect the executive compensation system, and the Planning Department monitors external factors which affect the goals set in the goal setting/performance appraisal process.

The external analysis done by the Planning Department greatly affects the goal setting process for the corporate strategy. External variables are very industry-related, and specific to the division under consideration. External variables can be identified in every major segment of the external environment.

Recently, there has been a change. The departments are now being encouraged to identify and monitor variables important specifically to them. For example, the Mortgage Company would be very interested in the housing starts and rate of housing turnover in the cities in which they are located. Small business financing would not be as interested in these variables. Ultimately, a greater understanding of their external environment will help them do a better job in the marketplace.

For the Planning Department, the economy plays an extremely important role in forecasting future corporate performance. Both the macro and micro economic

environments are monitored. In Company C, the affluence of the microenvironment and its proximity to large business centers make the economy uniquely important.

Company C also uses competitor analysis and has done so since the second year of planning. First, competitors are watched for strategic moves, and second, competitors are used as a benchmark in judging performance by comparison. Since deregulation has opened the industry to more competition, consideration is given to current and future potential competition.

The variables monitored by the Planning Department affect executive compensation indirectly through the setting of goals and objectives. In other words, the information concerning projections must be correct, or setting objectives too high (no bonus) or too low (an inflated bonus) will result.

While the Planning Office identifies, monitors, and forecasts variables which affect the strategic plan, the Human Resources Department also identifies and monitors certain variables.

Industry and competitors' compensations systems were extremely important for the executive compensation system in Company C. Company C likes to attract and retain the best personnel, and uses a strategy of paying more to accomplish that. In order to position itself as a top

paying firm, a consulting firm is used to provide industry compensation data in general, and information about what the competition is paying in particular.

The economy was important, too, but inflation was not a major concern. At the time the field work was done, the proposed tax laws were being closely watched. Although, nothing definite about the revisions in the tax code was known, the outcome could influence bonuses and stock-options offered in the incentive plan.

All proposed external variables were important to Company C's compensation plan with the exception of inflation (see Table 7.1 for a summary of this information).

Proposition I.2. The internal variables which are thought to affect executive compensation are size of the firm, strategy and resulting structure, and financial constraints. Although no order of importance is postulated for these variables, the researcher found that culture and strategy and structure appeared to be more important than size of the firm and financial restraints.

Each person interviewed reiterated the fact that Company C has a planning culture. The Vice Chairman of the Board stated he/she felt that strategic planning was responsible for the turnaround in his/her company's financial performance. All persons interviewed in Company C

Table 7.1. External Variables That Affect the Design and Administration of Company C's Executive Compensation Plan, 1986.

Variable	Comments
* Industry	· extremely important
* Competitiveness	· extremely important
	· monitors this closely to ensure the firm maintains its reputation as a top paying firm
	· performance of company is judged against competitors, thus affecting goal setting
* Economic Conditions	· monitors both continuously
* tax laws	
* inflation	· inflation becomes important when rapidly increasing or steadily high

*Variables predicted and supported by literature.

seemed to be in tune with planning and the process as it functioned in the firm. In other words, there was an acceptance of responsibility for goal setting and goal achievement -- and these two things are a very vital part of the workings of the strategic management process.

Setting high goals for achievement and following through with excellence is reflective of the culture of the firm -- if a person does a good job, he/she will be rewarded.

Strategy and structure are also important. Looking at the current structure of Company C as compared to the previous structure (see Figures 7.2 and 7.1 on pages 216 and 215, respectively), the trend towards more clear cut profit/loss responsibility is obvious. The strategy of deliberate continued growth will provide even more opportunity for accountability in the future.

Size of the firm does not affect Company C's compensation system as much as in Company A and Company B. Primarily, Company C prefers to pay its top executives comparable to the top performers in the industry. Although the consulting firm factors in size, the sole emphasis is not a comparison of peers of a similar size in the same geographic region. Company C's preference is to pay above average for its size using the top performers in the industry as its peer group.

The financial constraint against the compensation system is reaching certain hurdle objectives. In order to pay out bonuses over the years, the hurdles must be passed. The Board of Directors would have a difficult time justifying bonuses if the company were not performing well. The internal variables are summarized in Table 7.2.

Proposition I.3. The forecasting of pertinent external variables which affect the compensation system is postulated. Forecasting of external variables is conducted by two departments -- Corporate Planning and Human Resources.

Corporate Planning and the Executive Officers do external environmental monitoring. Since many of the external variables directly affect goal setting, Corporate Planning participates in the forecasting. The economy is the primary variable that has relevance to compensation becasue the inflation rate and the outlook for the related industries (such as housing and small business start-ups) are derived from economic data.

Such information has a direct impact on corporate objectives setting and divisional performance objectives. These, in turn, impact the setting of executive, top management, and middle management goals. Of particular importance is forecasting for variables which affect the

Table 7.2. Internal Variables That Affect the Design and Administration of Company C's Executive Compensation Plan.

Variable	Comments
* Culture	· a planning culture makes the SCP work smoothly
* Strategy and Structure	· continued growth will provide more profit/loss accountability
* Size	· uses size to establish competitive peers as performance benchmarks
Financial Constraints	· firm must pass hurdles to activate bonus system

*Variables predicted in the literature.

establishment of long-term goals with rewards paid out over the long-term.

The Human Resources Department also does some monitoring, and some is done by consultants utilized by this department. Changes in tax law and competitors' incentive plans are two areas of direct interest to the Human Resources Department.

Proposition I.4. This proposition puts forth the idea that a strategic compensation system will allow modification of performance objectives of participants if there were a drastic change in a variable. Company C does not allow these changes to be made. The researcher noted that this idea had probably been discussed before, but no effective way to implement such an idea had been found. The arguments against such changes were based on maintaining the integrity of the system both to those inside of the firm and those outside of the firm.

Summary. In answering Research Question I, the following may be noted.

(a) The primary external variables are the economy, particularly tax laws, competitors compensation systems, and industry.

(b) The primary internal variables are culture, strategy and structure, size of the firm and

financial constraints. Although the order of importance cannot be proven, it is suggested.

(c) Forecasting of external variables which could affect executive compensation is done by the firm and consultants. Within the firm the Planning Department and Human Resources Department both engage in forecasting of pertinent variables.

(d) Changes in major variables cannot be allowed to cause changes in performance objectives. Such changes would compromise the integrity of the system.

Research Question II.

The second research question focuses on the design and operation of the strategic compensation system in Company C.

Proposition II.1. This proposition asserts that the designers of the executive compensation system have knowledge of the corporate objectives and strategies, which is true for Company C.

The Vice President of Human Resources and the CEO and President of the firm have a close working relationship.

Since the top 50 officers contracts must be available for the Board of Directors to examine, the performance

contracts of all executives are seen by the Vice President of Human Resources.. Because the uppermost positions are scrutinized closely by the Board -- the Vice President of Human Resources helps to prepare these for Board approval. In order for the Vice President of Human Resources to ensure that contracts will meet with Board approval, he/she must be fully aware of corporate objectives and strategies.

Proposition II.2. The existence of points of information exchange between the strategic management process and the strategic compensation process is postulated. This can be proved in several ways in Company C. First, the 1985 Annual Report comments on the strategic management and reward system of the firm.

> We have created a goal-oriented environment which encourages (company name omitted) people to operate at the highest levels of creativity and productivity. This includes rewarding employees for exemplary service performance and new product ideas which increase revenue.
>
> At the same time, we balance this strong entrepreneurial drive with constructive bankwide controls and procedures which enable us to manage our business more effectively and efficiently.

Second, the appraisal form has this quote,

> This Managerial and Professional Performance Appraisal Form is designed to assist managers in reviewing and appraising performance. Performance Appraisal involves an examination of results in relation to set objectives and an analysis of how the results were achieved. This form was developed to facilitate discussion of individual performance, to document performance levels to establish objectives for the future and

> to provide guidance for improved performance. This procedure is also designed to provide employees with assistance in achieving individual objectives and the goals of the organization.

The goals of individuals are subsets of goals of the organization.

Monitoring performance was discussed in the interviews and the Annual Report. Individuals have their progress towards preset goals reviewed on a quarterly basis. Evaluation and control provide a strong link between strategic management and compensation.

Figure 7.7 shows how Company C regards the fit of Human Resources into the company's operation. Note that the Mission and Strategic /Operational Planning are inputs into the system. Inputs require information exchange. Rewards Systems and Performance Objectives and Standards are part of the Human Resources Planning and Management.

The information exchange between the SMP and the SCP for Company C is illustrated in Figure 7.8. This figure focuses on the relationship between the two systems in the formulation stage.

Proposition II.3. Executive awareness of corporate objectives, their own performance objectives, and evaluation techniques is proposed in II.3. This is indeed true for Company C. The top managers' monthly meeting with the

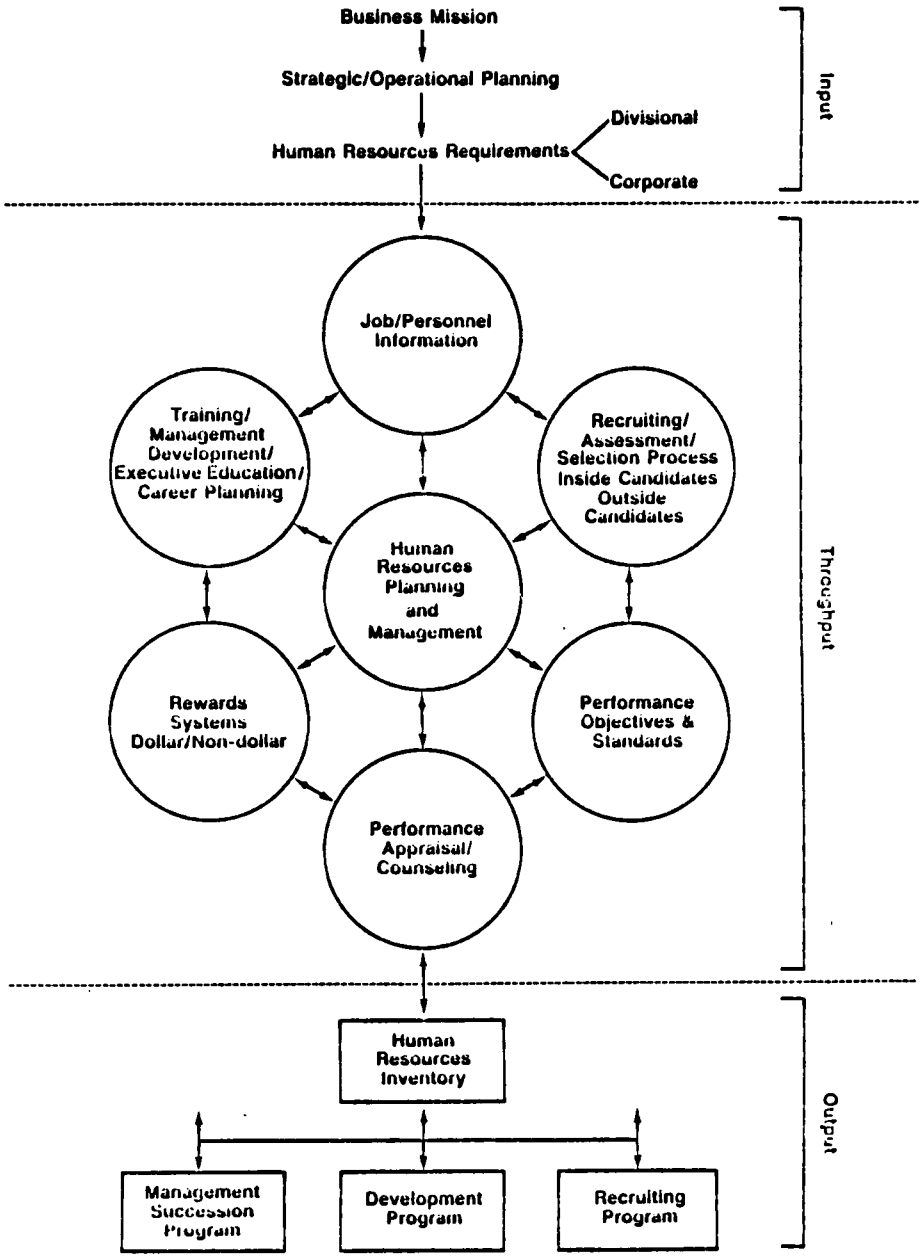


Figure 7.7. A Schematic of How Company C Regards the Fit of Human Resources in the Firm, 1986.

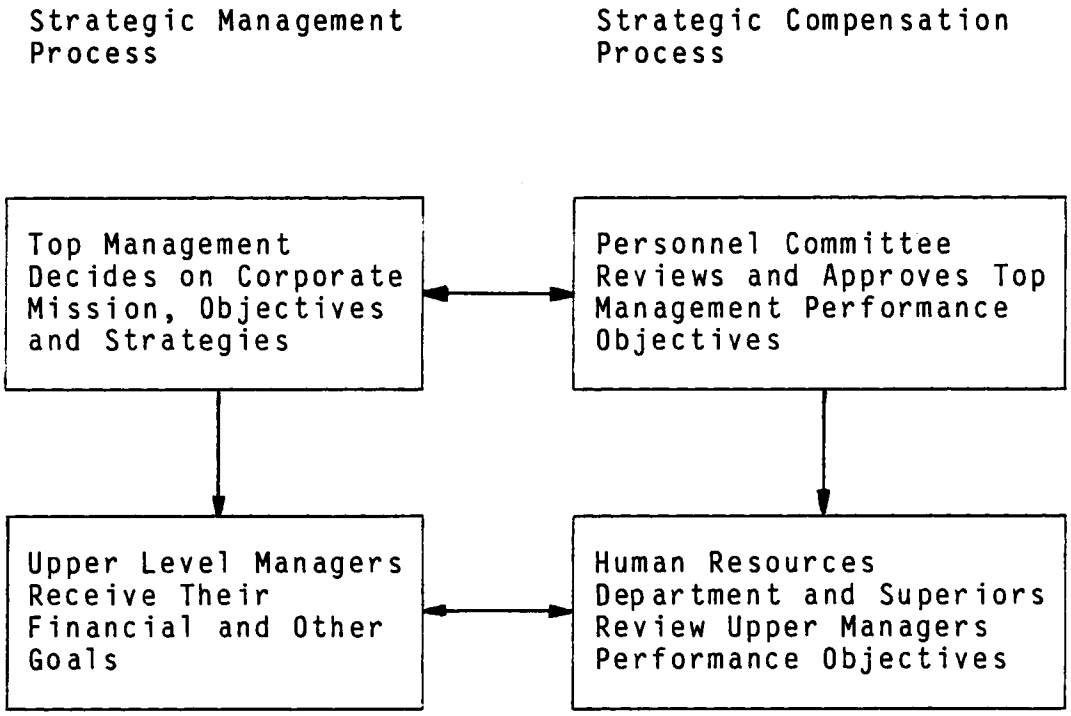


Figure 7.8. Information Exchange in the Formulation Stage Between the SMP and SCP in Company C, 1986.

President and Corporate Planning Department would provide reinforcement of the corporate objectives.

Corporate objectives are spelled out in the Annual Strategic Management Conference. They are reiterated when executives proceed to develop strategies for their units and departments.

Performance objectives are agreed upon by both superior and participant and they are formalized in the "Managerial and Professional Performance Appraisal". See Figure 7.9 for a small portion of this form used by Company C. Levels of accomplishment are stated in percentages (actual/objective) and these percentages represent a certain payout of bonus. The payout percentages are confidential.

In examining an anonymous performance appraisal, clearcut and quantifiable objectives were evident. Additionally, each job has a detailed description which provides the basis for determining performance. Although these descriptions may preclude flexibility; cloudy, uncertain responsibilities are diminished.

In Company C, executives certify their awareness of their performances objectives.

Proposition II.4. A formal mechanism for handling problems in the SCP is proposed, but does not exist in Company C. Although the system has been in operation for

Managerial and Professional Performance Appraisal

Objectives: In establishing objectives for future review be specific in indicating what is to be accomplished. Include the measure to be used for evaluation (i.e. loan volume), the minimum acceptable standard and the level to exceed standard. Objectives should be related to specific job tasks (refer to attached task descriptions) and stated in quantifiable terms.	**Accomplishment:** For each objective listed indicate the level of accomplishment. Results should be stated in measurable or quantitive terms whenever possible.	**Rating:** Indicate appropriate level of performance for each accomplishment. Unsatisfactory-UN Generally Satisfactory-GS Effective-EFF Highly Effective-HE Outstanding-OS

Other Accomplishments: Indicate other accomplishments which were not set as goals but were additions to incumbent's regular duties. (Emphasize problem solving accomplishments, innovations, etc.)

Figure 7.9. A Portion of the Appraisal Form Used For Establishing and Evaluating Performance in Company C, 1986.

years, that does not obviate the need for a formal mechanism. In the past, problems and suggestions have been handled as they appeared. The researcher felt this was not an important concern in this firm.

Summary. In answering Research Question II, the following statements may be made:

(a) The designers and administrators of the executive compensation system have working knowledge of corporate objectives and strategies.

(b) There are several points of information exchange between the SMP and the SCP.

(c) Executives know corporate objectives, their performance objectives, and how they will be evaluated.

(d) No formal mechanism exists for handling problems of suggestions in the system.

Summary and Conclusions

Company C was founded about 150 years ago and has been a community bank. In 1977, two such banks merged and Company C as it is known today emerged.

About ten years ago, spurred by unsatisfactory financial performance, top management instituted the process of strategic planning. Now, having used strategic

planning for ten years, the firm is a sophisticated planner with heavy top management involvement in and support of planning.

Company C has a Corporate planner who is responsible for the process of planning and for the development and coordination of the planning efforts of top management. Monthly meetings provided a forum for exchange between top executives of the firm. Top management commitment to strategic strategic planning was very strong.

Like Company A and Company B, the current strategy was one of growth. While the firm has expanded within the state, interstate expansion has been slow and deliberate. Some of the interstate offices are located near the "big money" banks, but Company C expands selectively into niches.

The compensation plan has both short-term and long-term components. Top management believes in accountability and rewards for good performance. Many incentives systems operate simultaneously at all levels of the organization. The firm pays above average for top executives because it wants to attract and retain good top management.

Company C's management is optimistic about its future success despite a hostile, turbulent external environment.

CHAPTER 8

CROSS CASE ANALYSIS

Initially, this study did not intend to draw the sample from one industry. Because the comparability of firms in the same industry was considered to enhance the value of the cross case analysis, the decision was made to include only companies in the banking (and finance) business. While that does eliminate a large degree of variability in possible firms considered for inclusion in the sample, the banking and finance industry now has firms with structures, forms, and relationships that were previously unknown and illegal.

Since the deregulation of the industry began, the number of possible competitors considered a part of the industry has increased. This is true not only of who the competitors are, but it is also true of where the competitors are. For example, interstate banking will remove previously existing artificial physical barriers to competition.

The term banking and finance industry has traditionally had rather clearly defined participants. This is no longer true because many nonbanks have skirted the intent of the law to engage in various functions previously left to banks. Without the binding restrictions of the banking industry, nonbanks can enjoy the profits without the rules.

Research Question I

The first research question addressed the issue of external and internal variables considered in the design and administration of the strategic compensation of eligible top executives, and how the system identified and accommodated changes in these variables. A brief synopsis of the answers to the propositions is found in Table 8.1.

Proposition I.1.

The first proposition postulated that industry, competitors in that industry, and economic conditions, particularly tax laws and inflation would be the external variables that most affected executive compensation. The identification of external variables considered in the design and administration by all three firms was almost identical.

First, industry was of paramount importance. In all of the firms, industry was described and discussed almost as if it were the environment in which the other variables, both internal and external, were considered. Of concern was the changing definition of the industry, but executives seemed uncertain as to how this would affect compensation directly.

In order to understand industry as the context in which the compensation systems operate, it is necessary to discuss the second variable, competition in the industry. All firms paid eligible top executives

Table 8.1. Answers to Research Questions I.

Research Question I	Propositions	Answers
What internal variables and external variables are identified and considered in the design and administration of strategic compensation systems for the eligible group of top executives, and how does the system identify and accomodate changes in these factors?	I.1 The major external variables which will be considered by firms are industry, compensation systems of competitors in the same industry, economic conditions, particularly inflation and tax laws.	Company A, Company B, and Company C all considered these to be major external variables.
	I.2 The major internal variables which will be considered by firms are size of the firm, strategy and resulting structure, culture, and financial constraints.	Company A, Company B, and Company C all considered these to be major internal variables, except that Company B was not currently concerned about financial constraints.
	I.3 Forecasting anticipates changes in the external variables which affect the executive compensation system.	Company A, Company B, and Company C all utilized forecasting for variables that directly and indirectly affected the SCP.

Table 8.1. (Continued)

Research Question I	Propositions	Answers
	I.4 Major changes in these internal and external variables are used to modify corporate performance objectives and executive performance objectives.	None of the respective companies had a system whereby major changes in these variables could accommodate parallel adjustments to to executive performance objectives.

according to a self-defined set of competitors within the industry. In each case, the set of competitors fit the traditional image of the banking industry. In no case was the set of competitors indicative of formal recognition of the change in the composition of the industry. While executives were cognizant of the increasing number of untraditional competitors with various legal structures, they were not yet incorporating these competitors into the working definition of the industry.

All firms in the sample utilized information about what competitors are paying when designing executive compensation systems. All three of the firms engaged a consulting group to have access to data about competitors in their industry. Company B appeared as concerned with providing evidence of objectivity to the shareholders with regard to executive compensation as with being competitive. Company C emphasized using the information about competitors to facilitate their reputation as a company that pays better than average base salaries, and then uses incentives in addition to the base.

Therefore, while all of the firms utilized data about competitors in the industry, there were distinct differences in both the definition of competitors and the ultimate purpose for which the data were used (see Table 8.2).

Table 8.2. The Different Emphasis of Utilization of Information About Competitor's Compensation Practices by Companies A, B and C.

Company	Definition of Competitors	Utilization of Information
Company A	Regional sample of similar sized firms	To be competitive To retain top performers
Company B	Regional sample of similar sized firms	To be competitive To protect corporate culture and public image of objectivity
Company C	Nationwide sample of similar performers	To be competitive To maintain their reputation of paying higher than average

Economic conditions were considered by each of the firms under consideration. Increases in yearly base salaries were based on increases in the cost of living in the geographic area in which each company was located. Inflation is the determining factor, although it is not as troubling a consideration as it once was.

At the time the data was gathered, the most pressing issue was handling the impending changes in the tax law. All three firms indicated exasperation in having continually to modify compensation to accommodate changes. Over the last ten years, tax law changes have been sweeping and frequent -- a major source of trouble for continuity in compensation systems. Both Companies B and C mentioned the fact that they are relying on consultants to help them handle these changes.

In conclusion, Proposition I.1 has been supported by the evidence and indicates that the primary external variables are industry, competition, economic conditions (of the region), and tax laws. Since inflation has moderated, it is no longer a current major source of concern, but it is still a primary economic variable which was monitored closely by all the firms.

Proposition I.2.

Proposition I.2 proposed the major internal variables to be size of the firm, strategy and resulting structure, culture and financial constraints. While all of these

variables were found to be of importance in each company, there was a definite difference in the order and magnitude of importance in each company (see Table 8.3).

Company A's most important internal variable was strategy and the resulting structure. With seven line divisions operated with separate profit responsibility, a situation was created which lent itself to the development of a sophisticated and organization-wide incentive plan. Additionally, the fact that each division was increasingly responsible for its own external environmental analysis placed more responsibility on the division for meeting objectives.

Culture was also very important for Company A. Being paid to take risks and giving little leniency for not meeting objectives seemed an inherent part of the culture.

Size of the firm and financial constraints, though applicable, did not appear to be as important to executives. Since the firm identifies its direct competitors according to size for the purpose of determining appropriate pay ranges, it is safe to include it as an internal variable. Similarly, provision for bonuses and stock options must be made in the budget. To justify such bonuses and options, sufficient profits and cash flow are necessary.

For Company B, culture and strategy and structure were bound together, making it difficult to discern which

Table 8.3. Internal Variables in Order of Importance for All Companies in the Sample.

Company	Internal Variables
Company A -	Strategy and Structure
	Culture
	Size
	Financial constraints
Company B -	Culture and Strategy and Structure
	Size
Company C -	Culture
	Strategy and Structure
	Size
	Financial Constraints

of the two was more important. With a centralized authority clearly evident, there seemed to be much more involvement of corporate management into the divisions of the company, which is consistent with the culture of the firm. A smaller firm than Company A, Company B has a history of long-term employment and a single-mindedness about the type of people they hire. All of this combined to give a feeling of homogeneity in the firm.

As in Company A, size was utilized to determine the peer group for determining appropriate pay ranges.

Financial constraints were not mentioned as a variable in designing the executive compensation system; a recent large infusion of capital seemed to temporarily alleviate concern about a cash shortage.

In Company C, culture and strategy and structure appeared to be equally important in affecting the design of the executive compensation system. However, culture was chosen as the most important variable for two reasons. First, the company has grown and continues to grow with a desire to remain an independent firm. This has affected the attitude of all employees in a way that encourages excellence in every job from the parking attendant to the Chairman of the Board. Second, the company is willing to pay more for the best executives. Because people know they are paid more, they are willing to work harder.

Setting this example at the top is thought to permeate the company.

Strategy and structure determined profit responsibility. Division heads have targets for which they are held accountable. Payout is determined by the achievement of these targets.

Financial constraints were applicable in a positive way. Company C set aside a large sum for incentives, which was known to employees. This provided an open statement about top management's commitment to incentives.

In conclusion, strategy and structure and culture of the firms appeared to be the two most important internal variables. Size was used primarily to determine appropriate peers for comparison with regard to pay ranges. Indirectly, though, size contributed to structure as well. For example Company B's smaller size was a factor in the relationship between corporate and business strategy. Financial constraints did not appear to be extremely important in the design and administration of the executive compensation system. Perhaps this was due to the credible financial performance of each of the given firms.

Proposition I.3.

Proposition I.3 predicted that forecasting will be done for external variables that affect the executive compensation system, which was true for all companies in

the sample. However, it was true because all companies hired outside consultants to forecast changes in the external environment. Gathering information about competitors' pay and making predictions about changes in the future was done by consultants.

Variables affecting executive compensation were monitored by designers and administrators of executive compensation, but the actual data gathering and forecasting were left to consultants.

Perhaps there is good reason for the utilization of consultants rather than doing this type of research in-house. Gathering this type of data is tedious and expensive and getting information that is recent and very specific is much more difficult. Consulting firms can afford to pay for the latest executive compensation plan information because they will get their money's worth out of it. Individual firms cannot afford to buy them.

Some forecasting of external variables which affect compensation indirectly is done by the Companies in the sample. As these firms continue to grow and become more divisionalized in structure, the division executives will have to become more responsible for the specific, narrow data that affects their particular business.

In none of the firms do executives pass off responsibility for external monitoring to the consulting firms. All of the CEOs/COOs expressed concern about

specific environmental issues and about continued monitoring of these issues.

In all of the firms, monitoring and forecasting of external variables fell into two categories. One set of external variables affected goal setting for the corporation and subsequently for top executives and everyone else. The general condition of the industry and the economic forecasts impacted goal setting.

The industry as a framework, competitors' compensation systems, and the economy, particularly inflation and tax laws, impact the executive compensation system directly. When these variables change, a good chance exists that some component of the executive compensation will change. These changes were anticipated, while the indirect response to the general industry and economic environment were not proposed.

Proposition I.4.

Proposition I.4 proposed that major adjustments to corporate performance objectives due to changes in the external and internal variables will cause modification in executive performance objectives. Overall, this was found not to be true. Once corporate performance objectives and subsequent executive performance objectives are established, they do not appear to be changed easily. While executives acknowledged the ever-present possibility of major unexpected changes in the external environment,

they seemed to be resigned to the fact that these types of changes simply mean no bonus.

The COO of Company A explained this phenomenon in terms of risks. Executives are paid to take risks, and if they fail to meet objectives they will lose. However, they often do achieve their goals, and for this they are well paid.

The CEO and Vice President of Planning in Company B pointed to the fact that the plan is subject to scrutiny by the stockholders. It would not be in keeping with Company B's organizational culture to make any adjustments to the executive compensation plan which could be construed as unethical.

Company C is cognizant of the problem and the Vice President of Human Resources stated there is a little flexibility due to extreme environmental circumstances, but not much.

Looking at these comments, there are two points of view. It is logical to alter performance objectives if some large unexpected shock occurs in the external environment -- after all, the corporate objectives are often adjusted up or down when this type of event occurs. Equally logical is the idea that the integrity of the system may be perceived as failing by outsiders (stockholders or others) and insiders (employees who do not participate in the plan).

In conclusion, both external and internal variables are considered in the design and administration of executive compensation systems. The importance and content of the variables makes each firm's compensation system unique. Forecasting is left to specialized consultants in the field. Currently, no satisfactory method of changing executive performance objectives, except at the regularly scheduled times, has been developed even though a major change in a variable or variables may make the original performance objective unattainable.

Research Question II

The second research question asks how the strategic compensation system operates and how it is designed. The various propositions of Research Question II will be answered in the following sections. A brief synopsis of the answers to the propositions is found in Table 8.4.

Proposition II.1.

In order to achieve integration of compensation and strategy, designers of the executive compensation plan should be familiar with the corporate objectives and the strategy of choice to meet these objectives. In all companies in the sample, this was true. Vice President of Human Resources is an appropriate generic title for those in all the companies who were charged with the successful

Table 8.4. Answers to Research Question II.

Research Question II	Propositions		Answers
How does the strategic compensation system operate and what is its design?	II.1	Designers of the executive compensation system where strategic compensation planning is employed are knowledgeable about what the corporate objectives are and what the chosen strategy is to meet those objectives.	In Company A, Company B, and Company C, designers of the SCP were aware of corporate objectives and strategy.
	II.2	There are several identifiable points of information exchange between the strategic management process and the strategic compensation process.	Identifiable points of information exchange were found in the formulation, implementation, and evaluation stages in Company A, Company B, and Company C.
	II.3	Executives are made aware of: (a) corporate objectives and (b) their performance objectives, and they know how they are to be evaluated with regard to their compensation.	In Company A, Company B, and Company C formal mechanisms existed to make executives aware of both corporate objectives and their performance objectives.

Table 8.4. (continued)

Research Question II	Propositions	Answers
	II.4 Designers and administrators of strategic compensation system have a formal mechanism to evaluate problems and potential improvements in the system.	No formal mechanism had developed in Company A, Company B or Company C.

execution of the plan. In both Company A and Company C, that the Vice President of Human Resources had close contact with senior line management was very obvious. In Company B, the individual who was in charge of executive compensation was also involved directly in corporate planning.

In all companies in the sample, monce the system was designed and in place, the line people made the system work. In each case, executives were responsible for helping their immediate subordinates establish goals, timeframes and strategies. In all companies, there was a mid-year performance review, and at year-end, superiors had to evaluate the performance of their subordinates. Evaluations were all based on the comparison of pre-established goals and the degree of completion of these goals in a satisfactory manner.

While top officers' performance was evaluated by a committee of the Board of Directors, most executives were judged by their immediate superior. The Human Resource Department was charged with calculations of bonus, incentives and stock options based on numerical interpretations of performance.

So, it seems that designers and administrators of executive compensation knew objectives and strategy, but this knowledge was necessary for getting the system started and keeping it functional.

Proposition II.2.

Proposition II.2 indicated that there are several points of information exchange between the strategic planning and strategic compensation systems, and that was found to be true. The systems operated very similarly in this regard.

First, all firms used both the actual corporate objectives and subsets of these objectives to formulate the performance goals of executives. All had a way of handing down corporate and divisional goals and strategies, and then negotiating, more or less, to finalize them. Once established at the upper levels, these objectives served as the starting point for management further down in the hierarchy.

Company A's plan, for example, was far more integrated into the entire corporation, with the inclusion of much lower levels of management into the system. Here, fragments of corporate level goals were pushed further down and used as the basis for establishing the performance objectives of individuals.

Second, the implementation of working towards these goals was, in essence, the implementation of corporate strategy. This was the case for all of the companies, but to a larger extent in Company A.

Third, since the goals established for individuals were actual subcomponents of the corporate strategy, a

type of dual control system was activated. In other words, the goals of the company became the goals of the individuals. Checking, collectively, the actual performance against established goals of individuals, is the same as checking the actual performance of the firm against established goals.

The formulation of corporate objectives and strategies is a point of information exchange between systems. When persons in the firms implement their individual goals, they are actually implementing a component of the corporate goals. Finally, the measurement of individual performance is a partial measure of corporate performance. Therefore, there are points of exchange and even congruity of these systems in formulation, implementation and control.

Proposition II.3.

In Proposition II.3, it was postulated that executives know corporate objectives and their own performance objectives, and how they will be rewarded for their performance. In all three companies, this proposition was correct. The performance agreements for each company specified objectives and a timeframe. Both the position of an individual and the level of achievement in that position determine the bonus which is paid out. While discussing the different levels in large organizations would be a vast undertaking, an outline of

the system to all participants should be provided. People are often curious about their pay in relation to everyone else's. Employees A and B of Company A expressed a desire to know more about the overall plan.

Proposition II.4.

A formal mechanism for improvement in the system was suggested in Proposition II.4. No such mechanism existed in any of the companies. In Company A, where the Management Incentive Plan was less than a year old, suggestions were made regarding the need for better and more division specific measurements of performance. These suggestions are being considered on an individual basis. However, the Vice President of Human Resources indicated that the process is evolving and he/she expected modifications to occur over time.

While Company C had no formal mechanism, the climate in the organization was such that all suggestions for improvement are seriously considered.

In conclusion, the most striking aspect of these strategic compensation systems was their explicit nature. The systems are formal mechanisms within the companies, and operate in conjunction with strategic planning. The executives in all companies firmly believed in strategic planning and in the power of incentives to motivate good performance.

The Development of a Practical Model

Since one of the purposes of this study was to develop a model which practitioners could utilize as a reference for initiating SCP in their firms, such a practical model has been developed (see Figure 8.1). While the researcher did not expect to find much similarity in the SCP between the three firms, the findings contraindicated that expectation. Figure 8.1 represents a synthesis of the data gathered during the study.

In Figure 2.7 (page 70), a theoretical model of the relationship between the SCP and the SMP was proposed. Although a useful reference in developing the Research Questions and resulting Propositions, the results of the field work indicated that the development of another model was warranted.

Specifically, the internal environment appeared to have some givens that acted as constraints equally on the planning process and the compensation process. Those constraints needed to appear obviously on the model as specific variables to be recognized for their potential effect on the operation of the systems.

Because the emphasis of the two types of external analyses is different, a separate external analysis must be shown for the SCP and the SMP. Even though both formal and informal communications channels permit information

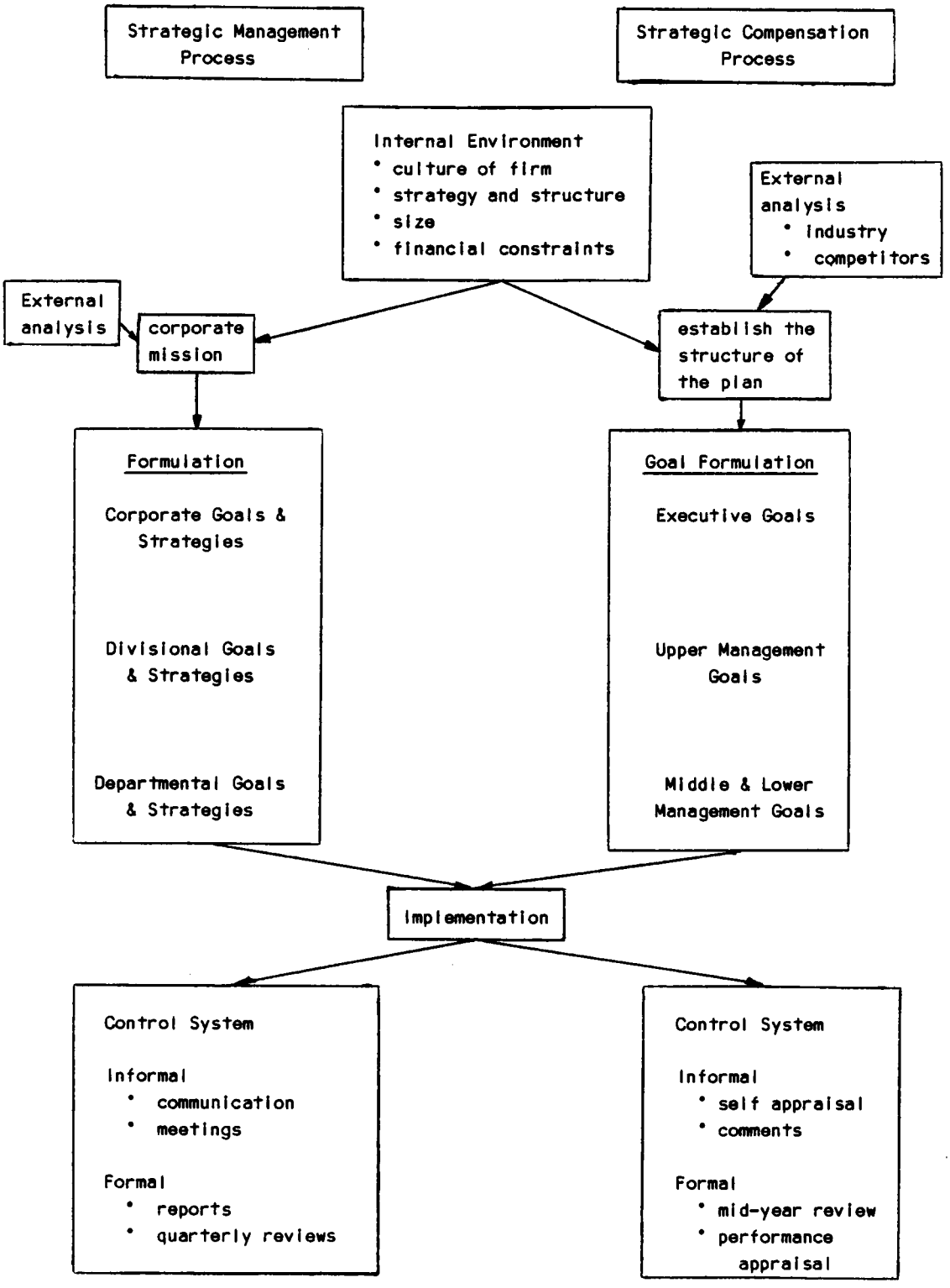


Figure 8.1. A Practical Model of the Relationship Between the Strategic Management Process and the Strategic Compensation Process.

about the specific external environments to be exchanged, in reality, the two analyses are not congruent.

In the formulation stage, the enumeration of the three levels of goals and strategies in the SMP and goals in the SCP is necessary. In the theoretical model (see Figure 2.7 on page 70), the enumeration was missing. The structure of all companies in the study was divisional even though the extent of decentralization varied greatly in this small sample. Perhaps the fact that all firms had divisional structure was coincidental, but if not, then practitioners should be aware of the difficulty of assigning meaningful measures of performance in non-divisional structures.

While implementation and control are shown correctly to be highly interrelated in the theoretical model, the differences in the control system are not identified. Even though the differences are subtle, the importance of these differences cannot be overlooked. Both the SMP and SCP have formal and informal control systems. The primary difference between the two lies in the informal system in the SCP, which relies on the personal interpretation of the executive or manager. The informality is compounded by the fewer number of personal performance appraisals per year as compared to the number and type of informal and formal appraisals of company performance. For the

practitioner, this is an area of potential concern in instituting an SCP.

One positive element, though, is that a built-in control system operates in strategic compensation. If executives know performance objectives, they will attempt to attain them. Having a set standard is a built-in control. Additionally meetings, reports, and performance appraisals all serve to provide feedback.

If the incentive compensation system can be pushed further down into the organization, as it was in Company A, then the control system is enhanced even more. At lower levels, the SCP also provides communication about strategy to those who might not ever hear it. The more middle and lower level managers that are included, the greater the number of points of information exchange.

While Figure 8.1 is a more realistic and useful model for the initiation of a strategic compensation plan in organizations, practitioners must be warned that such a plan should not be undertaken without close examination of the firm's culture. These plans require a portion of the organization's resources and the further down the organization the plan is operating, the more effort that will have to be exerted. Training people in MBO is time consuming and requires considerable commitment on the part of the Human Resources Department.

Summary and Conclusions

The internal variables which affect the design and administration of the executive compensation system are primarily organizational culture and strategy and resulting structure. The size of the firm is important in establishing benchmarks for comparison with peers. Peers are determined by top management. Financial constraints are important in that certain hurdle figures must be reached for incentive plans to operate. They are also inherent in the system because the firm has to make enough money to pay out bonuses.

The external variables that affect executive compensation are indirect and direct. The indirect variables are those that are used for forecasting of the corporate goals and objectives. The same variables are used to determine the goals of executives, the industry and the economy are the two primary ones, and political/legal aspects have become important recently as well.

The variables which directly impact executive compensation are the industry, competitors systems, and the economy -- particularly tax laws and inflation. Both tax law changes and inflation wax and wane in importance. Currently inflation is low and tax law change effects are not yet fully known.

Forecasting of indirect and direct external variables is common practice. Indirect variables to the SCP are direct variables for the SMP, and forecasting is done by executive officers (corporate level), divisional officers, and consultants. Direct variable forecasts are normally provided by consultants, especially to find information about competitors compensation systems.

Little seems to be available now with regard to modification of objectives for firms. Once a contract is made, it stays in effect.

Strategic compensation systems are unique in each company, but have some similarities worth noting. First, designers of the systems know about corporate objectives and strategies, usually through an open, close relationship with the executive officers, and by virtue of their position -- usually Vice President of Human Resources. Second, participants in the system know corporate objectives, their own objectives, and how they will be evaluated. Third, there was no formal method for making improvements in the system. Fourth, there are several points of information exchange between the SMP and the SCP. In formulation, the relationship between the SMP and SCP is primarily focused on formulation of performance goals. When implementation of strategy begins, the SCP is automatically implemented. In control, both informal and formal information exchanges occur. Formal exchanges come

in the midyear review and performance appraisal. Informal exchanges come from informal meetings, self-evaluation, formal meetings and memos. Both types of evaluation are important to the smooth running of the systems.

Since companies in the sample evidenced similarities in the way their SMPs and SCPs operated, a model was developed to incorporate these similarities. Because the model was based on the way functioning SCPs operate, practitioners may be able to utilize the model to initiate an SCP in their respective firms.

CHAPTER 9

CONCLUSIONS OF THE STUDY

The final chapter contains a summary of the study, implications of the study and its relationship to the field of strategic management, limitations of the study, and suggestions for future research.

Summary of the Study

In order for strategic management to be optimally effective, all systems within an organization should facilitate the achievement of both short-term and long-term objectives. While most areas within a firm are considered and included in strategic management, one important area has been ignored. This area is the compensation of executives.

Traditionally executives are expected to think about both the short-term and the long-term goals, and then are compensated for the achievement of short-term goals. There is an inherent contradiction in devoting resources to strategic management with its long-term implications, and then paying executives for short-term results. It is this inherent contradiction that prompted interest in the relationship between strategic compensation systems and strategic management.

While the majority of firms do not pay executives in any form for the achievement of midrange or long-term goals, a small number of firms are doing so. Since little detailed information is available about the design and administration of such systems, called strategic compensation systems, an exploratory case study was designed.

The study examined strategic compensation systems in three companies engaged in banking and finance. Initially each company was looked at individually, and then a cross-case analysis was performed. Two research questions addressed the most basic issues -- What are the variables used in design and administration of strategic compensation systems? How do these systems operate?

The exploratory case study makes no attempt either to discuss or to claim causation. It merely seeks to answer the research questions asked prior to the actual case study itself. Furthermore, the ultimate goal of the exploratory case study is to determine if further research is warranted in a particular area.

Across cases, the results indicated internal and external variables are identified and monitored in the design and administration of the strategic compensation system; although, each firm emphasized different variables. Forecasting of most of these variables was done through a hired consultant. Also, while executives

knew that unexpected major variations in these variables can preclude the achievement of corporate and executive goals, there was no vehicle for modifying goals.

Each company had its own sequence of planning events and its own method for compensating executives. Structure played an important role in the way the system was designed and operated. All of the companies had a classic history of the development of their strategic planning system. Each firm has been using (or trying to use) strategic planning for about ten years. All firms are now using it in the fullest sense of the word, and all find it to be continuously evolving.

Strategic compensation is newer, but the management of all firms see an inherent value in involving more people in strategic planning and rewarding them for doing so. All of the top executives believe in the power of the incentive to motivate. All were interested in learning more about how other companies were tackling the problem of keeping the emphasis on short-term and long-term performance balanced.

One method of doing that already existed in all three companies. Designers of strategic compensation systems knew corporate objectives and strategies. Executives were aware of what their specific goals were and the strategies which would be sanctioned to achieve them. By communication links between the two systems, progress was

measured and reported at designated intervals. All systems were evolving, but none had a formal mechanism for reporting areas that need improvement. Informal mechanisms did exist. None of the companies had intentions of abandoning the systems.

Because the purpose of the exploratory case study is to decide about the correctness of devoting more resources to research within the area, it is now appropriate to conclude that more research is warranted.

Implications of the Study and its Relationship to the Field of Strategic Management

First, strategic compensation systems (SCP) have great potential in companies practicing strategic management. One effect could be wider awareness of corporate, divisional, and departmental objectives. Additionally, the further down into the company the system operates, the greater the potential for influencing functional strategies. The SCP can provide many individuals with a chance to contribute directly to the achievement of organizational objectives.

Depending on the structure of the firm, there is the potential to overcome detrimental intraorganizational rivalries. The SCP can be designed to reward a team effort. Staff persons also can be involved, which could ease some of the traditional strained relations between line and staff positions. The SCP makes virtually

everyone responsible for the achievement of organizational objectives.

For any given position, the SCP can focus the efforts of an individual rather than disperse them. Since objectives are spelled out, it is easier for people to know what they are really expected to do.

Second, the fact that all of the firms in the study had used strategic management for several years, seemed to provide them with the grounding necessary to accept and undertake another functioning system in the organization. While firms with little experience in strategic management possibly could undertake an SCP, it would seem unlikely. Firms that are experienced planners may have better communication systems than non-planners, and they may be "wired" for an SCP, since formulation, implementation and control are as much a part of the SMP as the SCP.

Third, as SCPs evolve and become an integral part of an organization, there may be the potential for either better financial performance or improved longevity or both. With many employees aware of corporate objectives, and working on a subset of those objectives, the implication is that such a focused effort would enhance performance.

Fourth, as strategic management has evolved, more and more of the behavioral aspects of the planning process will be identified and considered. The relationships

between these behavioral aspects and the rational planning process will become part of the literature in the field.

Limitations of the Study

The majority of limitations of this study are directly related to the utilization of the case study methodology and the sensitive nature of the content of the study. Because deregulation in banking and finance has made competitive strategies so important, executives were wary about inadvertently divulging strategy content and obtaining more specific information which would have enhanced the study was impossible.

In order to be granted permission to do the study at all, companies wanted a guarantee of anonyimity and protection of identities of employees. While it is obvious why such protection is necessary, the reliability of the study is diminished. Future researchers interested in the area will be barred from examining memos, interview notes, proxy statements and other pertinent data. Replication of the study by anyone other then the current author is not feasible.

Relying on primarily company produced data is another limitation. Proxy statements, annual reports, 10-K's, interoffice memos, and other forms are all company documents. Interviews with executives provided a level of objectivity, but even this, in the strictest sense, is

company information. Because the topic itself is sensitive, little or no information about it is available in the public domain. The best corroboration available is through interviews of several people on the same subject and cross checking this with official publications.

Yet another limitation of this study is the way in which the sample of cases was developed. As described in Chapter 3, the method was a convenience sample. The criteria for inclusion in the study greatly narrowed the choices of companies which qualified. Then the company had to agree to be included. Several companies would not even send an annual report.

Every company which qualified on the criteria of strategic management and strategic compensation had to be approached through a contact. In no case did a company agree to be considered for inclusion without a contact who would vouch for the professional intent and integrity of the researcher.

Suggestions for Future Research

There are several areas for future research which result from this study. First, the study itself could be expanded to include a larger sample. This would necessitate going outside of New England because of the small number of firms utilizing strategic compensation. Second, the study could be replicated for other

industries. Of interest might be an industry currently operating in an environment not undergoing deregulation. Perhaps a mature industry in a stable environment and a young industry in a changing environment would lead to identification of different external and internal variables of importance. Third, a longitudinal study of the current sample to trace the evolution of the strategic compensation system over the next five to ten years could be conducted.

Another possible area of investigation was suggested by an observation made during the study. All of these companies have a long strategic planning history and a strong emphasis on the importance of planning. Is it possible that only those with such a history attempt to utilize strategic compensation? Perhaps those companies with a long strategic planning history are more willing to give such an undertaking more top level support and a longer experimental time period before giving up than new planners.

There is also the question of the financial results of such a program. Just as strategic planning is expected to yield benefits, strategic compensation is, as well. It would be of great value to determine the possibility of strategic compensation improving financial performance of a firm.

Finally, strategic compensation has possible application in nontraditional businesses such as public utilities and certain not-for-profits. Both of these types of firms would benefit users and clients respectively, if efficiency and effectiveness were increased. Strategic compensation in not-for-profits may produce some novel results.

Internationally, studying executive compensation practices in banking and finance as compared to the companies in the present research may indicate the usefulness of strategic compensation in other cultures. This will provide American firms with information about other cultural attitudes about rewards and incentives.

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APPENDICES

APPENDIX A

DEFINITIONS

APPENDIX A

The following definitions were used to describe various elements of executive compensation systems which are expected to be found in the three firms which are the subjects of this study.

Total Executive Compensation includes base salary, employee benefits, short-term performance plans, long-term performance plans, and perequisites (13, p. 23).

Base Salary is a predetermined payment usually apportioned over the period of a year for a year's service in a given position.

A Benefit is additional compensation given to employees as a reward for organizational membership; a benefit is a form of indirect compensation (41, p. 432).

Short-Term Performance Plans are executive incentive plans designed to pay out upon the attainment of specific goals which are usually, but not restricted to financial performance, to be achieved during the next performance year.

The Annual Bonus is a lump sum cash payment based on that year's corporate performance paid out soon after the end of that performance year (21, p. 3).

Perquisites are membership benefits given to individuals to the extent dictated by the level of their position in the firm rather than by level of performance. Categories of perquisites are: time off with pay, executive service, nonperformance awards, healthcare, survivor protection, and retirement coverage (13, pp. 23, 24).

Long-Term Performance Plan is an executive incentive plan designed to pay out upon attainment of specific goals, which are usually, but not restricted to financial performance, to be achieved over the next two to five years (23, p. 3).

The different types of long-term performance instruments currently in use are defined below. Companies may use only one of these, but it is more likely that some combination of these used. This does not preclude the use of variations of these definitions by the firms studied.

Stock Options are "rights to purchase company stock at a stipulated price over a specific period of time" (58, p. 27).

Stock Appreciation Rights (SARs) allow recipients to either (a) actually exercise an available stock option or (b) to take an appreciation in cash, stock, or some combination of the two (58, p. 28).

Restricted Stock Plans-shares are awarded to the executive (usually) without cost to the executive; the IRS imposes the restrictions of forfeiture if an executive leaves the firm before the lapse of a predetermined time period and if disposition of the stock during the time period is prohibited (20).

Phantom Stock-units, similar to shares of stock, are awarded to executives who will receive their value, usually in cash, at some point in the future. This plan differs from SARs in that there is no opportunity to exercise a stock option (58).

Performance Achievement Plans-awards units or shares earned for the achievement of preestablished financial goals (19).

Book Value Plans-are similar to stock option plans, but are usually found in privately held firms and book value is used instead of market value (58).

APPENDIX B

OPEN-ENDED QUESTIONS USED IN INTERVIEWS

APPENDIX B

The following open-ended questions were used in interviews.

1. What can you tell me about how this company started to use a formal planning process? What was the approximate starting date?
2. What is the planning process like today?
3. How did the planning process evolve into what it is today?
4. What is the timetable of the planning process? During a typical year, what are the planning steps and when do they occur?
5. What is the basic structure of your firm? Do you believe it to be centralized or decentralized in terms of decision-making?
6. Who formulates corporate objectives? How is this information conveyed to the next lower level of management? Into middle management?
7. Since you use a formal planning process, how is external monitoring accomplished? What variables are considered? How far in advance do you attempt to project these variables?
8. What happens to the corporate objectives if there is a major change in an important variable? What happens to bonuses and other forms of performance-based pay under these circumstances?

9. Do you do an internal analysis? How often? What internal factors do you consider important?
10. Who designed the current executive compensation system?
11. Could you describe the structure of the executive compensation system? Have any major changes in the system's structure occurred recently?
12. What are the long-term components of the executive compensation system?
13. How are executive performance objectives set? Can these be modified if some important internal or external variable changes, so as to render the previous goals virtually unattainable?
14. How are strategic management and strategic compensation related in your firm?
15. Do you believe that incentives help reinforce the achievement of corporate goals? At just the executive level? What about raises in base pay as opposed to performance-based pay?
16. What is the process by which executive performance is evaluated? What do executives know about the process in advance of their evaluation?
17. How often is performance evaluated?
18. What procedure do you use to accommodate changes which may become necessary?

19. Is there an exchange of information between those who determine corporate objectives and strategy, and those who design and administer executive compensation? Where and when do these exchanges take place?
20. Does your firm attempt to utilize incentive compensation at any other level in the organization?
21. Do you feel that the use of incentives helps your firm?
22. What external variables do you consider when designing and administering the executive compensation program? What internal variables? What is important about each?

VITA

Judith R. Hunt was born in Paterson, New Jersey in 1946. She attended school in Hawthorne, New Jersey and graduated from Hawthorne High School in June 1964. Like the daughter of many small business owners, she grew up working and learning in her father's firm--in this case, Superior Textile Engraving Works in Paterson, New Jersey.

In college she majored in Education and minored in Science, and graduated from Temple University in 1971. Ms. Hunt taught in public school for four years after her graduation. She returned to school at Farleigh Dickinson University, and in March 1980 was awarded a BS in Biology and an MBA in Accounting.

In September 1980 she entered the Graduate School at the University of Tennessee. She received the Doctor of Philosophy degree with a major in Business Administration in December of 1987.

The author is a member of the Academy of Management and is employed by The University of Rhode Island where she is an Assistant Professor of Management.