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COMPETITIVE STRATEGY AND THE DESIGN OF STRATEGIC BUSINESS UNIT GENERAL MANAGER COMPENSATION SYSTEMS

by

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Abstract

The purpose of this study was to identify the relationships between business unit level competitive and growth strategies and the design of strategic business unit General Manager pay systems. Previous research suggested that different patterns of pay plan designs would be associated with Porter's generic strategies and the parent's growth strategies. Another purpose of the study was to assess the effectiveness of pay plan designs, rarely addressed in prior research. A final objective of the study was to offer a contingency theory of compensation that offered a theoretical framework for strategic business unit General Manager pay plan design. One hundred four strategic business units comprised the sample. These units represented 19 of the 20 manufacturing Standard Industrial Code categories. Only business units with $25 million or more in sales revenues and at least 250 employees were invited to participate.

Generally, the data did not support the proposed relationships between generic and growth strategies and overall pay plan design. There was partial support for the proposed relationships between growth strategy and pay plan design including salary increase and incentive award determination methodologies. The results did support the concepts: that the evolution of common policy and design standards have become primary drivers of plan design; that organization complexity (i.e., type of diversification, the extent of resource sharing, work culture, and differing corporate and business unit agendas) leads to common play plan designs; and that the linkage between business strategy and pay plan design is driven by the actual goals more so than by the strategy for achieving those goals.

Three effectiveness factors emerged: competitive effectiveness, the extent to which the competitiveness of the plan supported business objectives; performance rewards, the extent to which the performance rewards process supported business objectives; and process effectiveness, the extent to which the procedural justice in the system contributed to supporting business objectives. The analysis revealed several relationships between the effectiveness factors and pay plan design. Those relationships suggest an emphasis on short-term incentives over long-term, a substantial portion of total pay in incentives, and ensuring that pay is competitive with the market.

Thus, while the present research found limited support for the propositions initially set forth, it did fulfill its second purpose, to identify relationships between pay plan design and effectiveness. It also identified several potentially powerful determinants of pay plan design that were more influential than business strategy.

Dedicated

to

My Family, Ruth Ann, Robert, and Brian

for their love and support

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INTRODUCTION

As organizations strive to improve their competitive advantage, in the face of international competition, the development of human resources strategies which are supportive of business strategies has gained importance. This heightened emphasis has been in part fostered by the popularity of Japanese management popularized by such works as: Theory Z (Ouchi,1981), which took us beyond Theories X and Y; and Peters and Waterman (1982), who took us in search of excellence by walking around, "sticking to the knitting," and being "close to the customer." In search of product quality, U. S. industry went to Japan and found an American, W. Edwards Deming, statistical quality controls, and quality circles (Peters and Austin, 1985).

Additional support is also coming from universities through the works of Kotter (1982), Maccoby (1981), and Levinson (1981) in their studies regarding the issue of leadership. Porter (1980 and 1985), Rumelt (1974) and Andrews (1980) have studied the formulation of corporate strategies. Fombrun, Tichy, and Devanna (1984), Ulrich (1987) and Schuler (1987) have focused on human resources planning. Tichy, Fombrun and Devanna, in a 1982 Sloan Management Review article, stress that human resources management is related to the strategic management of the business and is a key influence in directing organizational performance. A year earlier they proposed that human resources management should be elevated beyond its then largely operational role to a strategic role (Devanna, Fombrun, and Tichy, 1981). Porter (1980 and 1985) mentions the importance of rewarding performance and incentives to focus attention on key business objectives. Lawrence and Lorsch (1969) focus on the integrative aspects of human resources activities. Lawler (1983 and 1971), Freund and Epstein (1984), O'Dell and McAdams (1987), Kerr (1985), Broderick (1986), Balkin and Gomez-Mejia (1987b), and

Wallace (1990 and 1987) have studied the relationship of reward system design to corporate strategy and performance.

The notion that human resources management should support the accomplishment of the organization's strategic goals seems apparent.

SIGNIFICANCE OF THE STUDY

The human resources costs to an organization represent a major investment. In some industries, for example services, it represents the largest single cost. Even in capital intensive industries such as utilities, payroll costs, including benefits, are now at or exceeding 50 percent of operating budgets. (Lawler, 1971 and Maulden, 1987) A Bureau of Labor Statistics study revealed that "wages and salaries plus benefits that are paid in cash (paid leave and supplemental pay) accounted for 82.5 percent of the total compensation costs per hour worked" (Nathan, 1987 p. 4). This, coupled with the fact that a portion of the non-cash benefit costs, for example, life insurance and long term disability, are directly related to the wage and salary costs, means that wages and salaries are the most significant determinant of overall labor costs. This finding may help to explain Foltz, Rosenberg, and Foehrenback's (1982) conclusion that senior managers see the human resources function playing a critical role in the success of their firms. Given the costs associated with human resources, and the interest level of executives, the relationship between reward system design, business strategy and performance appears to be a substantive question to address. Further, Kerr (1983) points out there is "little empirically grounded, comprehensive theory on which to base reward system design decision" (p. 3).

A theoretical framework would be most helpful to compensation system designers. The implications of a contingency theory of compensation, which sets forth relationships between business unit strategy and the design of the compensation system are both obvious and important. At a minimum, it would help firms improve the effectiveness of how they spend scarce financial resources on their single largest cost factor.

SCOPE OF THE STUDY

Because there are potentially many different ways to conceptualize strategic planning it is necessary to use a typology which provides a sound structure. It is also necessary to develop a method by which the different reward systems variations can be classified. The development of a reward system framework and determining its relationship to business strategy are the ultimate objectives of this research.

It is necessary to develop a scope of study which is manageable. While compensation system design is important at all levels of the organization, this study focuses only on senior managers at the strategic business unit level. In a diversified firm, it would be the general manager of the strategic business unit.

Hofer (1975) suggested focusing on business strategy because over the long term a firm could not be successful at the corporate level until it could achieve success at the business level. He also pointed out that such a focus would require a smaller, less complex set of variables than focusing on corporate strategy would require.

Porter (1985, p. 36) states that, "the notion of the strategic business unit as the relevant entity for strategy formulation is well accepted. However, business units are often poorly

defined." Hofer (1975, p. 784) defines business level as "that level in an organization which responsibility for the formulation of a multi-functional strategy for a single industry or product-market arena is determined." Corporate level he defined as the top level of the organization regardless of the number of industries. In a single product line company the business and corporate levels would be the same. (Hofer, 1975) Dess and Davis (1984) building from Hofer (1975) and Rumelt (1974) followed Rumelt's single or dominant business categorization requiring that at least 70 percent of the business units sales had to be within a given 4-digit SIC code. This provides a methodology for meeting Hofer's criteria.

Some prior empirical studies of compensation system designs (Kerr, 1983 and Broderick, 1986) have not incorporated firm performance. Other studies have considered compensation system design and organizational effectiveness. Balkin and Gomez-Mejia (1987b) used acceptability of the compensation system as a proxy. They argued that systems which are accepted by business unit managers are accepted as valuable because they contribute to the unit's effectiveness (Balkin and Gomez-Mejia 1987b).

The purpose of this study was the identification of those compensation system typologies which are consistent with Porter's generic strategies, cost and differentiation. There are a number of systems used to classify strategic planning. Some have been the focus of prior studies of management compensation. Porter's has been the focus of studies related to control systems, resource sharing, manager selection, and administrative systems (budgetary evaluation, decentralization of decision making, and the manager's locus of control) (Govindarajan and Fisher, 1990 and Govindarajan, 1989 and 1988). However, Porter's classification model has not been used in the study of manager compensation systems. The research indicates such a study could yield useful results.

CHAPTER I

BUSINESS POLICY AND THE COMPENSATION SYSTEM

This chapter reviews various ways to conceptualize business strategic plans and compensation systems. The first section sets forth and discusses four aspects of compensation systems, performance appraisal, pay and benefits, promotions, and perquisites, used in prior research. The second section reviews business strategic policy and planning typologies used in researching a contingent relationship between business planning and policy and compensation systems. These include the degree and process of diversification (Rumelt, 1974), organization adaptation (Miles and Snow, 1978), the process by which growth was achieved (Pitts, 1976 and 1974), and Porter's (1980 and 1985) generic competitive strategies cost, differentiation, and focus. The third section reviews prior research on compensation systems design as it relates to these business planning models. It also reviews the related issues of organizational level and corporate governance as they relate to the compensation system.

COMPENSATION SYSTEMS

This literature review illustrates that there is no single or commonly accepted reward system or compensation system typology
or model which can be universally applied. There are, however, some common threads in the prior research. Therefore, it is possible to operationalize a reward system typology. Apart from intrinsic rewards such as responsibility, power, and recognition, there are four important aspects of a reward system performance management, pay and

incentives, promotions, and perquisites which constitute the core of compensation systems.

One of the tools top management has at its disposal to encourage the attainment of business objectives is the compensation system. The way compensation is allocated sends a powerful message as to what the firm deems important, those activities it wishes to encourage, and the level of performance it will reward. This section reviews the research in areas important to designing compensation systems. These are motivational theory, corporate strategy relationships, organizational structure, and corporate governance policies.

Incentive Pay Theory

Andrews (1980) points out that: "The influences upon behavior in any organization are visible and invisible, planned and unplanned, formal and not formal" (p. 140). Compensation systems influence behavior in a planned or unplanned fashion, and with some degree of formality. For example, performance feedback can be the result of formal appraisal forms and feedback sessions. On the other hand, it can be the result of the manager's gleaning feedback from the firm's or division's reporting processes. The executive who chooses to manage the influences upon behavior in a planned and logical fashion has at his/her disposal a variety of compensation tools. The task is to design a system which will support the business strategy. The challenge is to link the desired outcomes with reward outcomes that are valued by employees.

Four sets of interrelated theories (expectancy, reward, goal setting, and agency theories) provide insight into how that link can be established. Expectancy theory posits that employees will perform in directions they believe will result in rewards they value. The two underlying concepts are the expectation that a given level of effort will lead to a given level of performance and the expectation that the achieved level of performance will result in a reward desired by the employee (Wallace and Fay 1988, p. 79).

According to reward theory employees behave in ways that are rewarded. Building on expectancy theory, effective rewards are those that are valued by employees and are based upon the achievement of desired results (Wallace and Fay 1988, p. 80).

The third of the theories is goal setting theory. Goal setting theory directly addresses the challenge of linking performance objectives that are important to the organization with rewards valued by employees. It suggests that this can be accomplished through engaging employees in the process of setting mutual objectives. In this context, goals are outcomes which can include levels of performance, deadlines, or spending within budget. They can also include employee earnings levels and other rewards. Goal setting theory works because goals: focus attention on specific outcomes; get employees thinking strategically about performance including the steps and timing required; require effort and, if appropriately challenging yet attainable, result in higher levels of effort; and require participation leading to higher levels of acceptance and performance (Wallace and Fay 1988, p. 81-83).

Underlying those theories agency theory plays an important role in designing pay programs for Strategic Business Unit General Managers because General Managers are not owners. There is an agency relationship between the owners and the General

Managers. In the case of Strategic Business Unit General Managers, the agency relationship is between the General Manager and his or her superior who is also most often an agent. According to agency theory, owners need to establish control and monitoring systems (e. g., outside board directors, separate Chairman and Chief Executive Officer positions, and a large block stockholder) and/or pay systems, particularly incentives, that result in benefits to the agents and the owners. Reward and goal setting theory suggest methods for developing those mutually beneficial goals. When appropriate goals and rewards are established monitoring and control techniques are less necessary. When they cannot be established increased monitoring and control are required (Beatty and Zajak 1994).

Finally, the reward system communicates what activities the firm values. Compensation actions reward behaviors, activities, and outcomes. Since behaviors, activities, and outcomes vary according to the business strategy, the firm's governance systems, and different organizational levels it follows that the reward system design will vary accordingly. The research indicates that compensation systems are different.

Performance Appraisal

The performance aspect of a reward system includes performance criteria, the measurement technique, and feedback to the executive. Kerr (1983) and Broderick (1986) point out that

performance criteria can be objective or subjective. Objective criteria include such factors as profit, return on investment, growth, and earnings per share (Broderick, 1986). Subjective criteria, on the other hand, include such factors as inter-divisional relationships, communications skill, and originality and inventiveness. Performance

criteria can pertain to only the executive's division, or they can include corporate performance measures (Kerr, 1983).

Measurement techniques likewise are objective, formula based, or subjective and discretionary. Objective, formula based techniques provide varying levels of rewards based on performance thresholds. In subjective plans, individuals are assigned to performance categories or granted awards at the discretion of the higher level executive.

Feedback on performance can be formal, informal, or nonexistent. Kerr (1983) found that firms which used a mix of divisional and corporate criteria had formal feedback processes using appraisal forms and review meetings. Firms which used quantitative criteria based on divisional performance used either highly informal feedback or no feedback at all. Kerr concluded that this occurred because information on the objective criteria and divisional performance were readily available and well known to the division executives. In essence the system provides its own feedback. Where the criteria were mixed and the measurement criteria subjective specific feedback was needed and provided.

However, there are some indications that common standards are evolving, standards that are not related to business strategy.
Articles in the "practitioner" literature and training materials suggest the use of observable behaviors and objective criteria are acceptable and appropriate. Lawler, et al. (1984) suggested design criteria focusing on observable behaviors. Deardon (1987) suggested that profit center managers be rated on variance from budget. An American Compensation Association professional training course on designing performance management systems suggests objective criteria such as return on equity and profit goals

or observable behaviors (American Compensation Association, 1992).

From an organizational perspective there are advantages to a common set of standards. Within an organization they provide a common measurement tool for assessing performance, determining pay, and selecting individuals for promotion. If different units use different designs and criteria, the task of defending or justifying the allocation of rewards becomes more complicated. A standard set of criteria and a common methodology can increase the perception of procedural justice (the methods by which the outcome is determined) and distributive justice (the outcome itself).

Nevertheless, common standards can limit an organization's flexibility in tailoring the pay system to the business unit's needs. This can be desirable if the organization is attempting to control or limit the independence of a business unit. This lack of flexibility can be moderated if the specific criteria are tied to the strategies, objectives, and goals of the business unit.

Monetary Rewards

Rewards include base pay, salary increases, incentives, promotion increases, and perquisites.

Base Pay Salary Increases and Incentives

In developing a compensation program it is necessary to address the level of compensation in comparison to the market; the proportions of total pay which will be allocated in base pay and incentive pay; the methods and criteria for increasing base pay

and determining incentives; the administrative procedures and policies which provide a sense of procedural justice; and the salary structure(s) (pay grades and ranges) which will be used. Salary structures are not considered in this study because it is focused on the pay for the Business Unit General Manager, a single position.

Salary levels can be at, above, or below the salaries in the labor market. They also reflect a firm's philosophy as to the importance of internal equity relative to market competitiveness (Wallace and Fay, 1988). As with performance, salary increases are determined by objective criteria or subjectively. They can also be based on items other than performance such as tenure. Broderick (1986) found a relationship, though not significant, between membership (continued employment) as a basis for salary increases and firms classified as Defenders. (The Strategic Policy Models section following describes the strategic models referenced.)

Incentives, whether objectively or subjectively determined, can be focused on either short-term or long-term performance. Short-term awards are usually annual cash awards. Long-term awards are generally stock or a mix of stock and cash and based on performance over a three to five year period. Kerr (1983) found that 'evolutionary' firms emphasized divisional performance and 'steady state' firms emphasized corporate performance when determining incentives. Kerr (1983) also found differences in the ranges of payments. The evolutionary firms provided a wider range of payments than steady state growth firms.

Two of the issues which a firm needs to address are: competitiveness and mix. First, it must determine the overall level of direct compensation in comparison to the market place. According to McAdams (1996, p.99), the standard premise is that the amount of

the merit pay budget is based on the company's performance and on the competitive market. McAdams posits that there is some truth in both statements, but that while the market is the real driver of the size of the merit increase budget the firm also needs to determine the mix of base salary and incentives. The issue underlying mix is the extent to which an executive's earnings are at risk. The higher the ratio of incentives the greater the portion placed at risk.

Promotions

Promotions are an important aspect of a rewards system. Promotions serve two purposes, matching people to jobs and rewarding employees who aspire to higher pay and prestige. In tournament promotion systems the best performer at each level is promoted. In doing so, they provide performance incentives for employees. One side effect of the system is that the best performer at one level is not always the best candidate of the higher level position. Dual track career systems attempt to solve the problem, but fail when the higher level technical positions have rank but no meaningful purpose. Tournament systems cannot simultaneously provide incentives and match people to jobs (Baker, et al. 1988). According to Baker, et al. (1988), for matching to matter employees must have differing abilities. For tournaments to provide optimal incentives, employees must be of like abilities. Differences in abilities lead to reduced incentive effects if employees know those of higher abilities will win the promotions.

Kerr (1983) found that promotions can be based on potential as opposed to being primarily rewards for past performance. He also found that evolutionary firms