

## STRATEGIC REFERENCE POINT THEORY

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*How can executives achieve a match between expected external environmental conditions and internal organizational capabilities that facilitates improved performance? This paper argues that a firm's choice of 'reference points' can help achieve strategic alignment capable of yielding improved performance and potentially even a sustainable competitive advantage. Building upon prospect theory and other relevant theoretical perspectives, the strategic reference point (SRP) matrix is developed. A firm's SRP consists of three dimensions: internal capability, external conditions, and time. A theory is developed which posits an optimal SRP structure, and propositions are offered which articulate the expected relationships between the SRP, strategic choice behavior, and firm performance. The paper closes with some suggestions for using strategic reference points in both research and practice.*

A classic problem in the field of strategic management has been how to establish and maintain a match between expected external (environmental) demands and anticipated internal (organizational) resources. Thirty years ago, Chandler (1962) helped frame this problem as the relationship between strategy and structure, concluding that the former drives the latter. Andrews dealt with this issue by articulating the need for strategic alignment: 'Opportunism without competence is a path to fairyland' (1971: 70). Hofer and Schendel also enunciated the centrality of alignment by defining strategy as 'the match an organization makes between its internal resources and skills (sometimes now collectively called competencies)

and the opportunities and risks created by its external environment (1978: 12).

Since the external environment is constantly changing, often in unpredictable ways, maintaining this match or alignment is no easy task, and usually involves the need to overcome particular internal deficiencies or build new capabilities over time (Galbraith and Kazanjian, 1986; Prahalad and Hamel, 1990; Barney, 1991). Itami (1987) captured this need well with his concept of 'dynamic fit,' observing that the role of management in today's world is both to create and destroy alignment. Management must work hard to send consistent messages and align strategies, systems, and processes to achieve high performance. However, the organization must also be challenged continually to acquire new competencies so that it might be positioned for the future (Hart, 1992). Thus, strategic alignment

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entails the need to build, continuously, distinctive firm competencies in time to capture emerging external opportunities.

But what is the appropriate role for top managers to play in choosing a particular strategic alignment? How can executives achieve the dynamic fit required to improve performance, or to gain a sustainable competitive advantage? How exactly can managers make these strategic alignment choices? The answers in part depend upon what you believe about how managers (and individuals) make choices. For example, neoclassical economic theory suggests perfect information, risk symmetry, and rational choice leads to an optimal, determinant outcome. On the other hand, if you believe rationality to be bounded, and decisions unlikely to be optimal, only satisfactory in the Simon sense, then you recognize no specific calculus is available, but that decision procedures are nevertheless valuable if they can ensure reasonably good outcomes, in this case, strategic alignment.

We here suggest a calculus based on prospect theory as a mechanism that captures individual, and we argue, organizational decision making, including strategic alignment decisions. Other methods are available to foster strategic alignment (e.g., altering reward and incentive systems). However, we submit, none have any more claim to descriptive accuracy than that proposed here.

Prospect theory has demonstrated that individuals use targets or reference points in evaluating choices and that behavior depends upon whether they perceive themselves as above (better than) or below (worse than) a specific target or reference point they choose (Kahneman and Tversky, 1979). Fiegenbaum and Thomas (1988) used prospect theory to describe behavior at the firm level; they found that organizations behaved as risk-takers when below a reference point, but as risk-aversers when above. An organization's (or decision-maker's) selection of a 'reference point' thus appears to have implications for strategic choice behavior. By signaling organizational priorities and overall direction, top managers, whether knowingly or not, focus the attention of organizational members on particular goals and objectives; in so doing, they define the *strategic reference point* for the firm.

This paper takes the position that understanding a firm's choice of reference points is one way to achieve strategic alignment, and further, perhaps

a way that is descriptively accurate as well as practical in application. It argues that top management can be explicit and deliberate in the choice of reference points, rather than passive or unaware. Furthermore, the theory developed here suggests that strategic behavior of organizations and their subsequent performance can be influenced directly by management's choice of reference points. This latter suggestion points toward a mechanism for testing the theory's potential, and for developing a method for practical application.

After a review of the relevant literature, the paper develops the strategic reference point (SRP) matrix which is composed of three dimensions: (1) conditions internal to the firm; (2) conditions external to the firm; and (3) time (i.e., past and future orientation). Firms are expected to vary widely with respect to which variables within each of the three dimensions of the SRP matrix they emphasize. A theory is developed which predicts that strategic choice behavior will be risk-averse when firms perceive themselves as above (better than) the SRP and risk-taking when below (worse than) the SRP. It is also predicted that firm performance will be influenced by: (1) the content and configuration of SRPs; (2) their frequency of change; and (3) the level of consensus between top managers and organizational members pertaining to SRPs. The paper closes with some suggestions for using the SRP concept in both research and practice.

## LITERATURE

It is now generally accepted that in the years immediately following World War II, the large, uncontested American market enabled many U.S. companies to be world leaders. This circumstance was particularly well illustrated by the automobile industry. Under these favorable circumstances, the American incumbents maintained a steady course, minimizing risk, while reaping the financial benefits of their superior positions (Dertouzos, Lester, and Solow, 1989). This philosophy led top managers to invest only in projects that promised high rates of return in the short term.

However, over the past two decades, many new (often Japanese) competitors entered the U.S. market armed with equal, if not superior technology. Adopting a longer time perspective, and

driven more by quality goals and market share than profitability, these firms transformed the nature of competition (Abegglen and Stalk, 1985; Womack, Jones, and Roos, 1990). Incumbent firms (typically American) were slow to recognize that the 'rules of the game' were changing. Locked into a particular set of assumptions about their own industry, the nature of competition, and strategic management, such firms were often unable to alter their behavior. To achieve strategic realignment, large-scale investments had to be made regardless of the implications for short-term profitability. Regaining competitiveness demanded new strategic choices and extensive organizational change. Such transformation required a broader vision and greater risk-taking. Top managers were required to select and deploy a different set of 'reference points' than had been used in the past. Through the articulation of such new reference points, managers and organizational members can be encouraged and enabled to alter their strategic choice behavior.

### Strategic choice behavior: Prospect theory

Previous studies have developed and tested three different models of strategic choice behavior. Findings from these studies are depicted in Figure 1 and are summarized below. The first stream of research (represented in curve 1) is based on the assumption that decision-makers, and hence, organizations, are risk-averse. Under this assumption, organizations will take risk only if they are compensated by higher returns. This means that for each strategic alternative, firms and managers will choose that alternative with the highest utility (Schoemaker, 1982). This is the rationale for the positive slope of curve 1 in Figure 1. Indeed, studies such as Conrad and Plotkin (1968), Hurdle (1974), and Bettis (1981) have confirmed aspects of the theory underlying curve 1.

A second stream of research (represented in curve 2), which began with the empirical findings of Bowman (1980, 1982), asserts that individuals, and organizations, may be risk-takers under certain conditions. Furthermore, well-managed firms appear able to increase returns and reduce risk simultaneously, suggesting an apparent 'paradox' in the risk-return relationship postulated in the literature associated with curve 1. This kind of behavior is represented by the negative slope of curve 2 in Figure 1. Studies such as Treacy

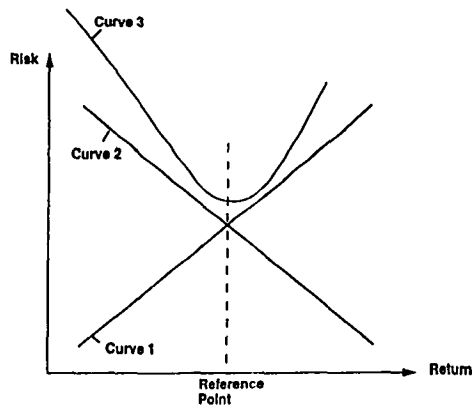


Figure 1. Three models of strategic choice behavior. Curve 1: risk-averse behavior. Curve 2: risk-seeking behavior and/or good managers can increase return and reduce risk simultaneous. Curve 3: risk-seeking and risk-averse behavior in the domain of losses and gains respectively

(1980), Fiegenbaum and Thomas (1986), and Cool and Dierickx (1987) have found evidence for this kind of 'paradoxical' behavior.

A third stream of literature (represented in curve 3) starts from a different perspective. According to prospect theory (Tversky and Kahneman, 1974; Kahneman and Tversky, 1979), choosing reference points which the decision maker is clearly 'below' should result in behavior measurably different from cases where reference points are selected which the decision-maker clearly exceeds. The major prediction of this approach is that organizations are *both* risk-averse and risk-seeking, depending upon whether decision-makers perceive themselves to be in the domain of gains and losses, respectively. Thus, prospect theory argues that decision-makers use targets or 'reference points' in evaluating risky choices (Kahneman and Tversky, 1979). Furthermore, individuals are not uniformly risk-averse, as has been implicitly assumed by many previous studies, but adopt a mixture of risk-seeking behavior when their expected outcomes from actions are below their reference point, and risk-averting behavior when expected outcomes are above their reference point.

This phenomenon has been confirmed by many studies where individuals, including managers, were the subjects (e.g., Crum, Laughhunn, and Payne, 1980; Fishburn and Kochenberger, 1979).

Furthermore, Fiegenbaum and Thomas (1988) found preliminary support for the use of prospect theory at the organizational level. Other studies, such as Singh (1986) and Chang and Thomas (1989), have also found evidence for a connection between strategic choice and organization-level reference points. In addition, Fiegenbaum (1990) presented evidence for another prediction of prospect theory in his empirical study that found the risk–return relationship for firms below the reference point was three times steeper than for the above-reference point firms. Curve 3 in Figure 1 depicts these findings.

Under the postulates of the third stream of literature, both individual and organizational choices appear to depend upon whether decision-makers see themselves as being above or below a 'reference point' used to describe their situation. Missing from the prospect theory literature, however, is any explicit discussion concerning the *content* of the reference point. While it seems clear that decisions can be altered depending upon how a problem is framed, there has been no explicit treatment of what constitutes an appropriate reference point at either the individual or organizational level.

### Related theoretical perspectives

As noted above, a classic problem in strategic management is matching the expected conditions of the external environment with the necessary internal capabilities and values of the organization (Andrews, 1971; Hofer and Schendel, 1978). In fact, several major theoretical perspectives from economics, psychology, and organization theory have sought to identify targets (or reference groups) which expose 'gaps' and thereby raise individual or organizational aspiration levels (March and Simon, 1958). Each, however, focuses upon different elements or areas of content in establishing reference points.

Table 1 provides an overview of each of these major theoretical perspectives. Motivation theory (Latham and Yukl, 1975), prospect theory (Tversky and Kahneman, 1981), and the resource-based view of the firm (Wernerfelt, 1984; Barney, 1991) each emphasize the importance of *internal* goals and capabilities to organizational behavior and effectiveness. Similarly, industrial organization economics (Porter, 1980), resource dependence (Pfeffer and Salancik, 1978), and insti-

tutional theory (Meyer, Scott, and Deal, 1983), all posit, in one way or another, the importance of *external* points of reference to strategic choice or firm survival. Finally, the literatures on corporate identity (Dutton and Dukerich, 1991) and strategic intent (Hamel and Prahalad, 1989) both emphasize, among other things, the importance of *time*, with the former focusing on past traditions and values and the latter on future, long-term purpose and direction.

Each perspective from the literature described above appears to share one important theme in common: the selection of a benchmark or 'reference point' against which strategic choice or organizational behavior is judged. However, each perspective deals with different content that might comprise a reference point and posits a different mechanism of comparison. Industrial organization economics, for example, establishes 'competition' as the primary point of reference, whereas the resource dependence perspective and institutional theory expand the set of external concerns to include suppliers, customers, and other important non-economic stakeholders.<sup>1</sup> Similarly, the resource-based perspective establishes physical, human, and organizational assets and capability as the primary reference dimensions, whereas motivation theory focuses more at the individual or group levels. Corporate identity and strategic intent, while clearly containing content, demonstrate the importance of the time dimension in establishing reference points—the former with respect to the past, and the latter with respect to the future. Taken together, the different perspectives suggest a broad range of potential reference points. Each perspective constitutes a 'piece of the puzzle' that defines a particular decision frame, thereby creating a gap or aspiration level for the organization.

## THE STRATEGIC REFERENCE POINT MATRIX

To develop a theory of strategic reference points, therefore, it appears necessary to consider internal, external, and time dimensions, treating them simultaneously as a multidimensional pack-

<sup>1</sup> Of course, Porter (1980, 1985) establishes an extended view of the industry in his Industrial Organization perspective on competition.

Table 1. Related theoretical perspectives: a summary

Theoretical perspective	Reference point emphasized	Fundamental prescription	Citations
Motivation theory	Internal organization <ul style="list-style-type: none"> <li>● Individuals</li> <li>● Groups</li> </ul>	Design work and set goals for performance	Latham and Yukl (1975) Nadler and Lawler (1977) Hackman and Oldham (1980)
Resource-based view	Internal organization <ul style="list-style-type: none"> <li>● Firm-wide resources</li> <li>● Capabilities</li> </ul>	Build unique competencies	Wernerfelt (1984) Pralhad and Hamel (1990) Barney (1991)
Industrial economics	External conditions <ul style="list-style-type: none"> <li>● Industry</li> <li>● Key competitors</li> </ul>	Beat the competition	Bain (1956) Caves (1977) Porter (1980)
Resource dependence	External conditions <ul style="list-style-type: none"> <li>● Suppliers</li> <li>● Customers</li> </ul>	Minimize constraints on resources	Pfeffer (1972) Pfeffer and Nowak (1976) Pfeffer and Salancik (1978)
Institutional theory	External conditions <ul style="list-style-type: none"> <li>● Stakeholders</li> <li>● Interdependencies</li> </ul>	Meet demands of society	Meyer and Rowan (1977) DiMaggio and Powell (1983) Meyer, Scott and Deal (1983)
Corporate identity	Time <ul style="list-style-type: none"> <li>● Past traditions</li> <li>● Philosophy</li> </ul>	The past shapes what is possible	Westley and Mintzberg (1989) Torbert (1987) Dutton and Dukerich (1991)
Strategic intent	Time <ul style="list-style-type: none"> <li>● Long-term purpose</li> <li>● Mission</li> </ul>	Strategic intent informs current decisions	Hasegawa (1986) Imai (1986) Hamel and Prahalad (1989)

age. As was argued by Tversky and Kahneman (1986) and others, however, there is no formal theory available for formulating reference points. It should be noted that the concept of a reference point has its roots in the psychology of perception. The argument is that human perceptual mechanisms appear to consider differences, rather than absolute levels, when evaluating alternatives (Festinger, 1954).

In laboratory studies on prospect theory, researchers have defined reference points in monetary terms. Other studies have tried to test this theory in 'real' situations. In this manner, Puto (1987) used either an increasing or decreasing price trend, a difficult-to-achieve or an easy-to-achieve budget, and a gain or loss message in a sales letter to manipulate the decision reference points of industrial buyers. Fiegenbaum and Thomas (1988) and Fiegenbaum (1990) used the industry's median return on equity (ROE) as the reference point. The reason for this reference point selection reflects the finance literature's suggestion that firms adjust their performance to the industry average (Lev, 1969; Frecka and Lee, 1983).

These studies indicate that any variable(s) that highlights a particular target or objective seems

capable of establishing a reference point and, subsequently, of creating a decision frame. Because there are several variables to consider, we propose a three-dimensional reference point 'matrix' which encompasses the wide range of variables identified in the literature review. Specifically, an SRP matrix is developed consisting of three major dimensions: (1) variables internal to the firm; (2) variables external to the firm; and (3) time (Figure 2).

### The internal reference dimension

As motivation theory and the resource-based perspective suggest, variables internal to the firm are crucial to success and constitute important reference dimensions for organizational members. Indeed, evidence suggests that the ability to build core competence appears to be critical to competitive success (Pralhad and Hamel, 1990; Ulrich and Lake, 1991). In this spirit, companies routinely set targets for *strategic inputs* (e.g., cost reduction, quality improvement, new product development) and evaluate employees' performance based upon these goals. Similarly, it is customary for firms to set targets for *strategic outputs* such as sales or profitability, and to hold

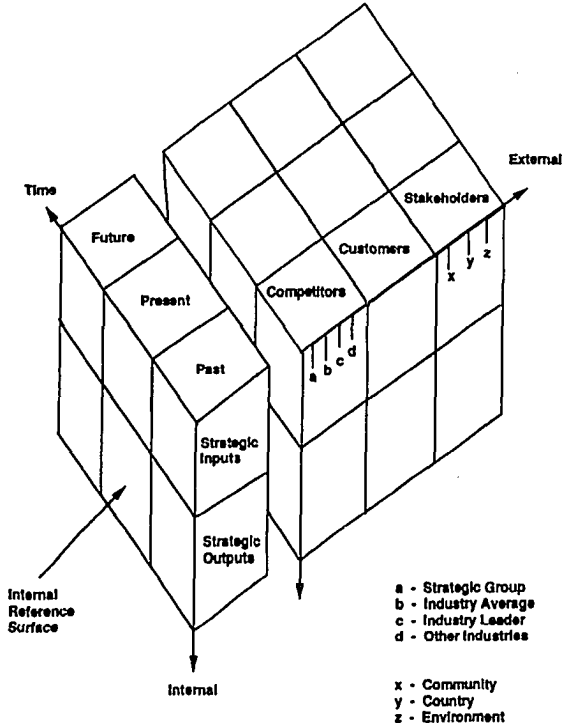


Figure 2. The strategic reference point matrix

managers accountable for performance against these targets.

### Strategic inputs

Internal capability can be conceived as developing around particular 'functions' or 'value-added' activities (Porter, 1985). Galbraith and Kazanjian (1986) identified this internal capability as a firm's 'center of gravity'—the driving force of managerial attention. Thus, organizations may seek to develop strong capability in technology (Steele, 1989), product development (Takeuchi and Nonaka, 1986), production (Cohen and Zysman, 1987), or distribution (Zeithaml, Parasuraman, and Berry, 1990). For example, Honda has used strong competency in technology (engines) to develop superior products in a variety of businesses, including motorcycles, automobiles, lawn mowers, and generators. In contrast, the primary internal reference point for Toyota has been production (e.g., just-in-time inventory control, qual-

ity control) rather than technology (Womack *et al.*, 1990). Companies like Domino's Pizza and Benetton, however, have clearly set distribution as a reference point, using delivery time as the primary operating target.

While firms may establish reference points around particular functions or value-added activities, most also emphasize one or more organization-wide capabilities which serve as a backdrop to functional operations; these 'cross-cutting' capabilities include an emphasis upon cost reduction (Porter, 1980), quality (Imai, 1986), speed (Stalk and Hout, 1990), and innovation (Foster, 1986). While some firms may focus on one or two of these capabilities to the exclusion of others (e.g., achieving a low-cost position vs. innovation), the themes are not mutually exclusive. In fact, it is becoming increasingly clear that all four competencies may have to be developed simultaneously to remain competitive in the coming years (Hamel and Prahalad, 1991). For example, Toyota has achieved a low-cost position

Table 2. Strategic inputs: the case of Crown Cork and Seal

Value-added activities		Cross-cutting capabilities		
		Cost	Quality	Speed
Technology	Minimize R&D cost			
Product development		Make the 'best' steel can		
Production		Pioneer production techniques	Fast line changeovers	
Distribution		Deploy sales engineers	Fill rush orders	

through total quality management and the reduction of cycle time, investing the resulting profits in aggressive programs for further innovation.

The value-added activities and cross-cutting capabilities can be used to create a matrix of internal reference dimensions (Table 2). An analysis of a firm's strategy and organization reveals which internal reference points are important in any particular case. Thus, a firm which aggressively targets cost reduction with its center of gravity in production will establish a set of internal reference points quite different from a firm which emphasizes technological development and product innovation. In this way, strategic choice behavior may be affected by which resources or capabilities are the focus of managerial attention.

As an example, Table 2 charts the input reference dimensions suggested by the well-known case of Crown Cork and Seal.<sup>2</sup> In the 1970s, Crown eschewed industry trends by sticking with steel in can-making rather than switching to aluminum. By focusing their efforts on production techniques facilitating fast line changeovers and rush-order fulfillment of two-piece steel cans, Crown succeeded in serving customer needs without incurring major R&D costs. Customer problem-solving was further facilitated by making knowledgeable sales engineers available as needed at customer sites. Competitors, on the other hand, were focused on lowering costs through economies of scale, long production runs, and offering the 'latest' aluminum can technology. By focusing corporate attention on the quality and speed of their production and distri-

bution capabilities rather than technology and product innovation, Crown pursued a different strategy compared to the rest of the industry incumbents. Thus, strategic choice can be significantly affected by the choice of internal reference dimensions.

### *Strategic outputs*

While strategic inputs are potentially important sources of reference points, so too are the strategic outputs or 'results' of the firm's operations. As noted above, most firms set explicit performance targets such as profitability (e.g., ROA, ROE, ROS), growth (e.g., sales growth or profit growth), or value creation (Rappaport, 1986). These output measures capture different dimensions of the firm's performance level and also serve to focus employees' attention in different ways. For example, it is now generally recognized that firms strongly oriented toward year-to-year profitability make very different strategic choices from those driven by sales growth, market share, or cash-flow over the life-cycle of a product (Abegglen and Stalk, 1985). Thus, the choice of which strategic outputs to emphasize is an important source of reference points for the organization.

### **The external reference dimension**

While self-reflection—the crux of the internal reference dimension—appears to be very important, so too is the comparison of oneself to external benchmarks. Indeed, as the industrial economics, resource dependence, and institutional theory perspectives make clear, it is essential to examine the position of the firm relative to important actors and circumstances in the external

<sup>2</sup> Crown Cork and Seal Company, Inc. Harvard Business School #9-388-096.

environment. Industrial economics focuses upon the firm in reference to competitors in the industry; resource dependence extends consideration to suppliers and customers and focuses upon the constraints or expectations that these external parties impose. Institutional theory is the most encompassing, and emphasizes the pressures placed upon the firm by the full range of organizational stakeholders. Given the diversity of external factors, it is useful to consider three major subsets of external reference dimensions: competitors, customers, and stakeholders.

### *Competitors*

Successful strategies are often characterized as those which outdistance the competition. Indeed, the most accepted external reference point in the literature on strategic management has to do with competitors (e.g., Porter, 1980) and the concept of 'competitive advantage' is premised upon sustaining a favorable position relative to competitors (Porter, 1985). The literature indicates that competitor reference points can be defined at several levels: the firm can compare or 'benchmark' itself to the industry as a whole, to a particular strategic group of firms in the industry, to the industry leader, or to competitors from other industries ('best-in-class' capability). For example, Lev (1969), and Frecka and Lee (1983) have shown that industry averages serve as targets for financial goals of many companies. At Komatsu, however, the reference point is its arch-rival Caterpillar, the dominant competitor in the industry. This target is captured well by the firm's slogan 'Maru-C' which means literally 'to encircle Caterpillar.' Increasingly, firms also seek to identify potential competitors—firms from other industries possessing technology or capability that might be applied in the incumbent's domain (Porter, 1980). Strategic choice thus appears to be greatly affected by the choice of which competitor reference point(s) is selected.

### *Customers*

While many firms emphasize competitor's actions as the primary external reference point, others are driven more by customer needs and seek to develop strong relations both with customers and suppliers (Ohmae, 1988; Peters and Austin, 1985; Peters, 1987). The stated mission of Nissan, for

example, has little to do with competitors; instead, the goal is to develop 'life-long customers.' This means painstaking assessment of customer needs and an analysis of the company's degrees of freedom in responding to those needs. A 'customer' orientation has important implications for organizational actions and strategic choice (Shapiro, 1988; Cornish, 1988). SAS provides a compelling example of this in the airline industry, where changing customer needs precipitated a wholesale reorientation of competitive strategy and corporate culture around the 'business flyer.' Thus, a 'gap' between customers' needs and the organization's ability to deliver on those needs results from comparison to an external reference point.

### *Stakeholders*

The third component of the external reference dimension relates to those concerns which historically have been treated as issues of 'social responsibility' (Anshen, 1980; Freeman, 1984). Here again, reference points can be formed at several levels, including local community relations (Henderson, 1990), national competitiveness (e.g., Dertouzos, Lester, and Solow, 1989), and environmental sustainability (e.g., Schmidheiny, 1992).

Many companies are concerned with nurturing good community relations. Being a good 'corporate citizen' means providing stable employment and contributing, where possible, to local economic development (Henderson, 1990; Freeman, 1984). Johnson & Johnson, for example, has long stressed the importance of corporate citizenship in its 'credo.' The issue of national competitiveness also provides a reference point for many firms. This is most evident among firms from developing countries. Consider, for example, the Korean firm Daewoo. In 1967, it started with an investment of \$18,000; by 1985, its revenue was \$14 billion. When Mr. Kim, the founder, and the CEO of the company was asked to explain why they have been so successful, he attributed his firm's success to his desire to show people around the world that Korea can produce the highest-quality products at the lowest prices.

Increasingly, firms also measure their success against how well their products or services contribute to environmental quality and sustainable development (Schmidheiny, 1992; Shrivastava



and Hart, 1992; Hart, 1995). DuPont, for example, aims to anticipate, seek, and respond to public values concerning the environmental impacts of its operations and has incorporated environmental concerns into the corporate mission. The company's recent decision to accelerate their exit from the CFC business due to the product's ozone-depleting properties is a good example of a 'stakeholder' issue supplying a reference point for a firm.

### Time as a reference dimension

As the corporate identity and strategic intent perspectives suggest, time is a critical reference dimension for the firm. The time dimension can be divided into two major categories: *past and future*. Today's strategic choices can thus be heavily affected by references to either the past (where the firm has been), or the future (where the firm would like to be).

The past is often an important factor in establishing reference points. Organizational learning studies have shown that firms which accumulate knowledge over time can use it as a source of competitive advantage (e.g., Shrivastava, 1983; Fiol and Lyles, 1985; Levitt and March, 1988). Building upon past excellence provides a reference point to spur continued achievement. Indeed, the financial literature has shown that investors and organizational decision-makers look at past performance in evaluating future alternatives (Lev, 1969). However, using the past as a reference point can also serve to constrain the strategic options perceived as viable by the organization. Dutton and Dukerich (1991), for example, have shown how the long-standing mission of New York's Port Authority as a 'transportation agency' limited its ability to recognize homelessness as a problem at its various facilities throughout the city. Only by redefining its identity as an organization—a break with past tradition—was it able to reframe the issue and adopt a different set of policies and behaviors toward homeless people.

The future also serves as a source of decision frames and reference points. Firms with a strong sense of strategic 'intent,' for example, may think a great deal about the 'deep' future—10 or 20 years out—when making strategic choices. Hamel and Prahalad (1989) noted that companies that have risen to global leadership invariably began

with ambitions that were out of all proportion to their initial resources and capabilities. Somehow, they created an 'obsession' with achieving a mission over a long time frame. At Mazda, for example CEO Yamamoto characterizes the company's 20-year investment in rotary engine technology as a 'sacred quest.' While it has yet to prove a commercial success, Mazda has steadfastly refused to give up on rotary technology. As a result of this commitment, Mazda is now only a couple of years away from introducing a *hydrogen* rotary engine which emits water vapor as a combustion waste rather than the list of serious pollutants associated with the conventional gas-powered engine.

### The reference surface

The Mazda example demonstrates how reference points are formed in practice: internal dimensions interact with external dimensions and the issue of time to create reference points on what might be called a 'reference surface.' For instance, Mazda has used a sense of strategic intent (future orientation) as a touchstone for maintaining its commitment to rotary technology: embedding today's strategic decisions in a long-term quest thus facilitates choices that might otherwise be difficult to make. Mazda has also created an external reference point with the hydrogen rotary engine—their 'clean' engine responds proactively to the mounting stakeholder demand for environmentally sustainable products. Thus, for any firm, the dimensions of the SRP matrix interact to form multiple targets and points of comparison.

## THEORY DEVELOPMENT

The SRP matrix could be applied descriptively in virtually any organizational setting. Beyond its use as a descriptive or diagnostic tool, however, the SRP concept should also have predictive (and ultimately, normative) value. In this section, we therefore develop a basic theoretical framework that can be used to help guide future empirical work. Theory and associated propositions are developed around two major themes: (1) the linkage between the SRP and *strategic choice behavior*; and (2) the relationship between the SRP and *firm performance*.

Table 3. Strategic choice behavior propositions

	Above reference point	Below reference point
Current situation	Satisfied 'Sitting on top of the world'	Dissatisfied 'At the bottom looking up'
Perception of new issues (Jackson and Dutton, 1988)	Threat Potential loss Negative	Opportunity Potential gain Positive
Organizational processes (Staw <i>et al.</i> 1981; Dutton and Jackson, 1987)	Constricted Rigid Centralized	Open Flexible Decentralized
Nature of response or behavior (Kahneman and Tversky, 1979)	Risk-averse Conservative Defensive	Risk-taking Daring Offensive

### Strategic choice behavior

The position of the firm relative to its strategic reference point (really a surface<sup>3</sup>) would be expected to relate to a number of significant cognitive, organization process, and behavioral characteristics. Table 3 contains a summary of these expected relationships. Jackson and Dutton (1988) have demonstrated empirically that issues categorized as 'threats' imply a negative situation in which loss is likely, whereas issues categorized as 'opportunities' imply a positive situation in which gain is likely. The former set of cognitions would be expected for firms above their SRP and the latter for those below. Thus, firms with 'everything to lose' (above the SRP) will tend to see new issues as threats, whereas those with 'nothing to lose' (below the SRP) should tend to see the same issues as opportunities.

Staw, Sandelands, and Dutton (1981), and Dutton and Jackson (1987) also proposed a number of links between issue categorization and organizational processes. They hypothesized that when confronted with a 'threat' issue (above the SRP), decision-makers will constrict information flow, become rigid by applying only tested repertoires, and engage in centralized decision-making. In contrast, decision-makers facing an 'opportunity' issue (below the SRP) will tend to be more open to new information, more flexible and willing to try new repertoires, and more willing to decentralize decision-making.

Finally, as prospect theory predicts, responses or behaviors should be risk-averse (conservative, defensive) where the firm's perception places it above its reference point and risk-seeking (daring, offensive) where below. The decision-maker's attitude toward risk is based upon their framing of the situation. In the case of the risk-taker, the decision-maker is *dissatisfied* with their current situation, seeing themselves as below where they would like to be. Conversely, the risk-averter is *satisfied* with their situation—they see themselves as 'sitting on top of the world.' An industry leader, for example, should be less inclined to take risk if decision-makers saw a particular action as carrying the potential of unseating the firm from its position of advantage. Thus, conservative behavior is expected in cases where firms have clearly met or exceeded their goals, whereas active risk-taking is anticipated in cases where firms are clearly below their target (Kahneman and Tversky, 1979; Fiegenbaum and Thomas, 1988). These expected relationships can be summarized in the following propositions:

*Proposition 1a: Firms above their SRP will perceive new issues as threats, engage in constricted, rigid and centralized decision-making processes, and behave in a risk-averse, conservative and defensive manner.*

*Proposition 1b: Firms below their SRP will perceive new issues as opportunities, engage in open, flexible, and decentralized decision-making processes, and behave in a risk-seeking, daring, and offensive manner.*

<sup>3</sup> In a three-dimensional framework, such a 'point' is in reality a plane or surface in the sense of being above or below a multidimensional reference point.

## SRP and firm performance

Four characteristics of the SRP are expected to have significant implications for firm performance: content, configuration, change, and consensus. The theory for each of these aspects is developed below, along with propositions for each.

### Content

Since strategic choice behavior is expected to vary depending upon whether the firm sees itself as above or below its SRP, the content of the reference point(s) is of critical strategic concern. The literature suggests that top managers play a central role in managing organizational attention through the articulation of the firm's vision and mission (Quinn, 1978; Bennis and Nanus, 1985; Westley and Mintzberg, 1989; Hart, 1992). Therefore, by choosing carefully which dimensions of the SRP to emphasize, it would seem that top managers can influence the framing of issues in a way that motivates organizational members and focuses their actions. The firm's performance should thus be directly influenced by its choice of a strategic reference point.

The three dimensions of the SRP matrix can be seen as capturing the basic 'structure' of the firm's vision and mission. Given the complexity of the matrix, however, it would be expected that great variation will be observed with respect to the actual configuration of reference points adopted by firms. Some firms, for example, might be primarily *internally* oriented, emphasizing one or more internal reference points to the virtual exclusion of external concerns. Others, however, might be primarily *externally* oriented, focusing primarily upon competitors or customers, while downplaying the importance of strategic inputs or outputs. In addition, some firms may be preoccupied with the *past*, basing important decisions upon history or tradition, while others are concerned more with the *future* trajectory of the firm.

Each element of the SRP matrix might also be expected to correlate with particular aspects of firm performance. A focus on competitors, for example, might be expected to result in market-share gains; a strong customer focus might result in higher product quality; and a concern with stakeholder issues should be associated with strong social and environmental performance.

Similarly, an internal emphasis upon cost position and production might relate strongly to profitability, whereas an emphasis upon speed and product development might correlate more strongly with growth. Finally, a 'mission' orientation might be expected to produce a strong emphasis on future positioning, whereas preoccupation with the firm's past successes might translate into a focus on greater efficiency and profitability.

Recently, a few authors have advanced arguments that effective strategic management requires a balancing and simultaneous mastery of seemingly contradictory or 'paradoxical' organizational capabilities: broad vision and attention to detail, an external as well as internal focus, and emphasis upon both flexibility and stability (Mitroff, 1983; Bourgeois and Eisenhardt, 1988; Torbert, 1987; Quinn and Cameron, 1988; Quinn, 1988; Hart and Quinn, 1993; Hart and Banbury, 1994). By applying the logic of 'paradox' inherent in the SRP matrix, firms can achieve balance and simultaneous mastery of seemingly conflicting activities and goals. Multidimensional, multivariate strategic reference points can help management direct organizational and individual attention to such multiple concerns. This line of reasoning suggests the following four propositions:

*Proposition 2a: Firms possessing both an internal and external reference point will outperform firms which are predominantly internally or externally focused.*

*Proposition 2b: Firms possessing both a past and future orientation will outperform firms which are predominately past or future focused.*

*Proposition 2c: Firms possessing multidimensional SRPs—a simultaneous emphasis upon internal, external, and time dimensions—will outperform firms with more narrow reference points, focused upon only one or two reference dimensions.*

*Proposition 2d: Firms possessing multidimensional SRPs will perform well on more dimensions (e.g., profitability, growth, quality, innovation, and social responsiveness) than will firms with more narrowly defined reference points.*

Beyond the specific content of the SRP, it is also important to examine the configuration or relationships among the different dimensions and variables comprising the firm's reference points. Contingency theorists (e.g., Thompson, 1967; Lawrence and Lorsch, 1969), and management theorists (e.g., Miles and Snow, 1978; Peters and Waterman, 1982; Galbraith and Kazanjian, 1986), have long emphasized the importance of *fit* between the different internal elements of the firm (strategy, structure, technology, systems, processes) and its environment. Applying this logic of 'fit' to the SRP concept under a multiple reference points regime, the most effective firms will demonstrate *internal consistency* among the dimensions and variables comprising the SRP. For example, where a firm identifies an industry leader as its primary external reference point, then its targets for strategic inputs and outputs should be demonstrably connected to the goal of overtaking that rival. If the rival possesses strong technological and distribution capability, then an internal reference point targeted at cost reduction and efficiency introduces inconsistency and, it is hypothesized, further introduces a destructive tension within the organization. Even where long-term mission or 'strategic intent' has been adopted that is far beyond current capabilities, the associated internal and external reference points should be identifiably connected to and consistent with the long-term aim. In short, the multiple dimensions of the SRP should be *mutually reinforcing*—on the 'critical path' to the ultimate goal. Where organizational members perceive mixed motives or conflicting targets, the effectiveness of the SRP will be blunted. This suggests the following proposition:

*Proposition 3: The most effective firms will possess multidimensional SRPs whose composite variables are internally consistent and mutually reinforcing. That is, the demands placed upon the organization for improvement, change, or performance by the reference points will align, producing a mission and vision with integrity.*

## Change

It is essential to consider the *dynamic* aspects of the SRP. While Proposition 3 suggests that the

structure of the SRP should be internally consistent and mutually reinforcing *at any given point in time*, this is not to suggest that the SRP should remain *fixed* over time. In fact, the literature on strategic change and adaptation suggests that organizations pass through periods of relative stability and equilibrium, punctuated with episodes of 'revolution' characterized by disequilibrium and divergence from the status quo (e.g., Greiner, 1972; Miller and Friesen, 1980; Romaneli and Tushman, 1986). The concept of 'dynamic fit' (Itami, 1987) asserts that a key role for top management is to create both order and chaos. Management must work hard to send consistent messages and align organizational strategies, systems, and processes to achieve high performance (Proposition 3). However, management must never allow the organization to settle into complacency. As soon as 'balance' or 'alignment' has been achieved, it must be destroyed. The organization must be challenged to acquire new competencies so that it might be positioned for the future. Thus, the SRP should continually evolve and change if the organization is to achieve *sustainable* competitive advantage. A static SRP might eventually lead to stagnation. This suggests the following proposition:

*Proposition 4: The most effective firms will continuously alter or revise their SRP to focus attention on new challenges and opportunities arising in their respective environment.*

## Consensus

The last characteristic to consider relates to perceptions about the SRP within the organization. The literature on top management team consensus indicates that agreement among top managers about strategic goals and competitive strategies is an important predictor of firm performance (Bourgeois, 1980; Hrebiniak and Snow, 1982; Dess, 1987) although the nature of the relationship appears to vary depending upon competitive environment and the nature of the strategy-making process utilized (Wooldridge and Floyd, 1989). There is also growing evidence that agreement *across* organizational levels concerning these issues is an important predictor of firm performance (Yeung, 1990; Hart, 1991, 1992). Indeed, the literature on corporate culture has

long asserted the importance of shared values and understandings to organizational effectiveness (Pascale, 1985; Peters, 1987; Weick, 1987). Thus, while the CEO, or even the top management team, may have a clear image concerning the firm's SRP, organizational members may not share the same perception, or may have conflicting images. Indeed, organizational members may interpret the signals being sent by top managers very differently than intended, resulting in a perceived reference point which diverges from the 'intended' SRP (e.g., Weick, 1979). However, if organizational members do not share the same perceptions about the SRP, then issues will be framed and decisions made in ways which run counter to the desired direction. A lack of consensus concerning the firm's SRP would thus be expected to have negative consequences for strategic behavior and firm performance. This suggests the following, final proposition:

*Proposition 5: The most effective firms will be characterized by high levels of agreement among top managers and organizational members regarding the content of their SRP.*

## APPLYING THE MATRIX

To apply the concept of the SRP, both in theory and practice, it must first be operationalized; variables comprising the dimensions must be defined, and a system of measurement and scoring devised for both variables and dimensions of the matrix. Complete operationalization of the matrix is a subject for one or more papers in its own right, but we can here outline the approach and the nature of the operationalization process.

Operationalization should be pursued both objectively and subjectively. *Objective* measures for each variable comprising each dimension of the SRP matrix can be defined using both secondary and primary sources. For example, R&D-, capital-, and advertising-intensity data could be used to indicate the level of firm focus on key 'internal' variables, such as technology, production, and distribution. To create a reference point for each dimension, these variables could be benchmarked against the industry leader, a particular strategic group, or the overall industry average. The resulting placement of each variable

'above' or 'below' each benchmark of the SRP matrix, coupled with a scoring system that could be devised, would lead to positioning the firm in the matrix dimensionally and in turn these dimension measures would allow investigation of the linkages between SRP, strategic choice behavior, and firm performance.

While objective measures of the SRP will be useful, it will also be necessary to develop a *subjective* measurement system. Here, sets of survey items could be crafted to tap each of the more subjective variables in the SRP matrix. Perceptual measures must be designed to determine both *if* a respondent perceives a particular dimension as a reference point for the firm (e.g., competitors vs. customers) and *whether* or not the respondent sees the firm as 'above' or 'below' the SRP. To be complete, data must be collected at multiple levels within the organization, including top managers, middle managers, and line employees. Such a 'SRP survey' would enable researchers and top managers to take the pulse of organizations and determine the extent of understanding and agreement concerning the firm's SRP. Comparing the objective and subjective results would yield important insights into the firm's strategic positioning and provide a basis for management intervention. Indeed, such a set of diagnostic tools would have important implications for both research and practice.

From a research perspective, operationalization must precede the design of studies to test the propositions proposed in this paper, and is the crucial next step to advance the conceptual and theoretical framework outlined above. From a practical perspective, developing and applying measures for the SRP matrix would provide useful links to the concepts of core competence and benchmarking which are currently discussed and utilized widely in companies. With regard to the former, the SRP matrix provides a conceptual framework that might be useful in operationalizing the notion of core competence. The development of a measurement system would help push this idea even further down the path of useful application. With regard to the latter, the SRP matrix helps clarify what elements to benchmark. For example, firms preoccupied with competitor benchmarking may find themselves playing a game of perpetual catch-up. Indeed, without establishing reference points for emerging customer and societal demands, it may be difficult to

position the firm in a way that offers a sustainable competitive advantage.

## CONCLUSIONS

By signaling what issues are important, top managers establish the strategic reference points for their firms—the benchmarks against which people gauge appropriate action and behavior. Prospect theory suggests that behavior will be risk-seeking when the individual or organization finds itself below its reference point, and risk-avoiding when above. To a great extent, therefore, the firm's strategic behavior and performance are influenced by the reference points which are consciously or unconsciously adopted.

Beyond the articulation of reference points, top managers can also seek to influence strategic behavior through restructuring, reallocating resources, or redesigning planning and reward systems. These interventions are complementary in that they reinforce the importance of the challenge embedded within the strategic reference point. Ultimately, through the management of reference points and other supporting interventions, the actual mental maps and schemata of organizational members might be shifted in the desired direction. At this point, the new behaviors have become internalized and no longer require direct management attention—they have become part of the identity and culture of the organization.

Thus, the SRP matrix provides both a research and diagnostic tool for assessing an organization's strategic alignment. It can also help assess the organization's ability to marshal internal resources and capabilities to take advantage of emerging opportunities and risks in the external environment. By explicitly 'managing' the reference point(s) used by their firms, we are suggesting that top managers may be able to influence both the nature and level of organizational risk-taking.

Since most prior work on the topic has failed to address explicitly the content of the reference point, we developed the SRP matrix. The matrix contains three dimensions—internal capability, external conditions, and time—that we believe capture the range of possible reference points. Based upon this matrix, we developed a set of propositions concerning the SRP. First, given

their strategic reference point(s), we predict that firms will behave according to prospect theory, namely, as risk-takers and risk-avoiders in the domains of losses and gains respectively. Second, we predict that firm performance will be directly influenced by the content and configuration of SRPs. Third, we predict that firms that periodically change their SRP will sustain performance over time. Finally, consensus about the firm's SRP among top managers and organizational members is expected to facilitate firm performance.

SRPs appear to have important implications for research in strategic management. For example, researchers from organizational theory, population ecology, economics, and finance have looked in different ways at the interrelationships between environment/industry, firm strategy, and performance. It is always assumed that structural elements of the industry or the content of the firm's strategy are the key factors that have to be considered. This paper argues that, in addition to these factors, SRPs, and the resulting attitude toward risk, represent another set of contingencies that impact performance. The SRP concept offers the potential to enrich the field of strategic management since it bridges the gap between economics and psychology. We hope that this paper will encourage researchers from the various and related disciplines of management to explore further the implication of strategic reference points.

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