Strategy and Human Resources: Concepts and Practice

Peter Lorange and Declan C. Murphy

INTRODUCTION

The strategic management of human resources is fast becoming a major issue in strategic management. For a variety of reasons, corporations are now coming to view scarce management talent as a critical strategic resource that requires the same careful allocation customarily reserved for money and technology (see, for instance, Murthy, 1977; Salter, 1971; Bickford, 1981).

This new seriousness of purpose with regard to the human resource issue is, in itself, a significant step forward. There can be little doubt, however, that business practices for linking strategic human resources management into an overall corporate strategy still require much refinement and improvement. As always, there is a necessary lag between the initial perception of a managerial need and its fulfillment.

The critical issue in strategic human resource management can be summarized as follows: How can the firm elicit an individual manager's commitment to the strategy it wishes to implement? From the firm's perspective, it is vital that its strategy result in an aggressive pursuit of the best environmental opportunities available. And effective pursuit of such external opportunities presumes an ability to assign the right kinds of human talent to the right positions within the firm. Furthermore, the firm must be able to allocate its strategic resources internally so that it accumulates sufficient strategic strength to outperform its rivals in its chosen areas of competition. In this context, human resource management must be viewed as an integral part of the strategic resource allocation processes of the firm. To engage the support of critical managers, the firm must design a work setting that allows them to perceive a congruence between their own aspirations and the overall corporate strategy.

The basic tone of the present article will be normative. We will, however,

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illustrate our arguments and theses with material from a recently completed empirical survey study (see Lorange and Murphy, 1983). Use of this empirical material will also allow the present paper to serve as a vehicle for the identification and dissemination of some critical issues that practicing managers expect to confront in this area in the years ahead.

Analysts have devoted considerable efforts to the development of more realistic conceptual schemes for setting the strategic direction of the firm. (See, for instance, Lorange, 1980, for an overview.) Further, there is a long tradition of research on performance evaluation, within the field of managerial accounting (see Anthony and Dearden, 1980; Horngren, 1977). Finally, the field of executive motivation and compensation has also been thoroughly researched, by micro-organizational and psychological schools of research (see, for instance, Steers and Porter, 1983; Lawler, 1976). We have not, however, seen fully explicit attempts to propose management systems and processes for bringing strategic planning, performance evaluation, and executive compensation together into one conceptual framework. The present article will endeavor to suggest how aspects of such a framework might look. We wish to stress that this article is exploratory in nature, and that its conclusions are therefore tentative. It is our hope that our work will stimulate others to formulate more precise, testable hypotheses, and more plausible theories.

In what follows, we shall discuss several issues surrounding the conceptualization and implementation of strategically focused human resource systems. As stated above, we will draw extensively on a recently completed empirical study of human resource planning practices in large U.S.-based corporations. This study consisted of structured interviews with thirty-four senior executives, of whom sixteen were the senior planners of their firms and eighteen were the senior human resource officers. Complete pairs of planner/human resource officer responses were available from twenty companies. Each interview lasted for approximately one hour and was carried out over the phone, after initial contact by mail and preliminary calls to set up the interviews in uninterrupted settings. The results of this study are, however, reported elsewhere (Lorange and Murphy).

A general proposition informs the logic of this article: in a rationally designed planning system, effective strategy implementation requires consistency between the firm's overall strategy and the personal aspirations of its management "stakeholders." In this case, the firm's executive assignment/promotion and incentive systems must facilitate, or at least pull in the same direction as, its strategy formulation and implementation procedures.*

* Throughout the remainder of this paper, we will use the term "incentives" to refer to executive promotion/assignment and incentive compensation systems.

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STRATEGIC TASKS

A strategic planning system, it is often argued, should possess a hierarchical structure that reflects a "division of labor" in strategy formulation and implementation between three distinct levels of the firm—the portfolio or corporate level, the business family or divisional level, and the business or product/market element level (Lorange, 1980, pp. 18–28; Lorange and Vancil, 1977, pp. 23–25). At each of these three levels, management will confront different (though interrelated) sets of strategic variables. It is critical for successful strategy implementation that the firm's promotion and incentive systems assist rather than obstruct the fulfillment of these varying strategic agendas.

We shall argue that to attain this crucial consistency across the firm's three levels of strategy, three sets of normative propositions must be valid. These propositions concern how human resource management systems can effectively contribute to the strategy implementation process at each level.

At the business or product/market element level, the principal strategic challenge is to reach a specialized set of customers with the corporation's own products or services in competition with clearly identified rival firms. Hence, the elaboration and implementation of competitive business strategies is the primary issue here. Our normative assumption at the business element level therefore is that human resources should be allocated so that the personal propensities and skills of a manager fit the requirements of a given competitive strategy. Furthermore, incentives should be delineated and administered to provide a reinforcement to the manager to pursue the prescribed strategy with genuine vigor.

To illustrate, mature, "cash cow" businesses and newly emerging businesses pose very different managerial challenges. In the former case, competitive success depends heavily upon highly efficient, cost-conscious management. A streamlined internal organization might significantly lower such a business's cost function and thereby provide it with critical competitive advantages. In the latter case, success in the competitive battle would probably hinge much more on the ability to "adapt" effectively to a rapidly changing environment by means of new or revised product and/or market alignments. Certain managers will excel at cost-conscious, efficient management in a relatively stable environment, while others will find their true metier in an entrepreneurial setting where the external parameters are constantly shifting. From a human resources point of view, therefore, the critical problem is the attainment of an optimal match between competitive strategic needs and the skills and strengths of individual managers.

At the divisional or business family level where several product/markets or business elements are grouped together, the key issue is the realization of synergistic efficiencies. For example, shared production facilities, sales

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force, distribution, or research and development all might be possible for a group of related products. In addition to these internal synergies, specific market conditions may also permit the realization of external synergies. Consider, for example, the case of a firm that produces stoves, refrigerators, and dishwashers. Rather than view their products as totally separate lines, the respective managers might be able to achieve synergistic efficiencies if they perceive "the kitchen" as a common focal point of their marketing efforts and coordinate their competitive strategies accordingly. An ability to capitalize on such synergies would result in significantly lower costs for the business family as a whole.

For the business family level, our normative assumption will be that human resource management should cultivate team work between managers of similar products to foster a spirit of cooperation that would facilitate the realization of any potential synergies. In this context, it is crucial to motivate managers to look beyond their own narrow business element "kingdoms" to the broader challenges of the business family unit. To rectify any tendency toward parochialism among business element managers, we hypothesize that a policy of dynamic management reassignment within the same business family would be appropriate. Under this arrangement, business element managers could expect assignments in both the more established, mature business elements of the family and in the newly emerging ones as well. Such in-house experimentation, we feel, can also provide an invaluable source of data for the eventual specialization of managers by business types referred to above.

At the corporate or portfolio level of the firm, the main task is the strategic success of the company as a whole. And success at this level depends to a large extent upon the development of a good fit between business families and their constituent business elements so that an overall balance exists within the company between strategic resource generation and expenditure. Obviously, for a company to survive and grow, it must generate more strategic resources than it uses over time. Moreover, there should be a reasonable economic and political risk exposure for the portfolio as a whole. Our normative assumption at this level of the firm concerns the desirability of perceiving general management talent as a strategic resource analogous to funds and the consequent deployment of these managers within the corporation so that they can contribute effectively to the development of the optimal portfolio of businesses of the firm.

STAGES IN THE STRATEGIC PROCESS

Figure 1 provides a schematic representation of a strategic management system as it would function at any of our three strategic levels (see Lorange, 1983). The figure describes a strategic management system that

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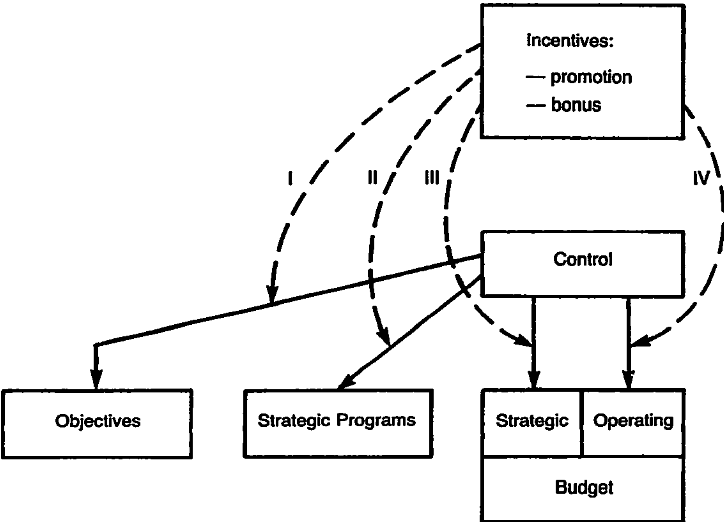

Figure 1. Strategic management direction-setting and control.

begins with an objective setting process in which the organization, through the sequential procedure, builds strategic focus by "narrowing down" options. The next step in this system is the development of strategic programs for achieving the chosen objectives. Having decided in the previous phase where it intends to go, the organization must here decide how to get there. Once the strategic programs have been set, a more detailed action plan for the short-run implementation of these programs is needed. The strategic budget fulfills the near-term aspects of this requirement. Finally, the operating budget reflects the activity levels and patterns stemming from the operations of the on-going business. This broad-stroke breakdown of the process into four distinct steps will suffice for the present discussion. A more elaborate "punctuation" of these steps is, of course, possible (see Mohr for a more general discussion of "punctuation" and stage delineation).

The management incentives process must simultaneously and directly address a manager's contribution toward the fulfillment of each of the four steps set forth in the figure: the setting of good and realistic strategic objectives with particular emphasis on sensitivity to critical underlying assumptions, the design and implementation of explicit strategic programs, the setting of, and ability to demonstrate performance against, strategic and operating budgets. Incentives should be designed to induce high levels of management performance on each of these tasks. Obviously, however, the standards used to measure and reward performance will

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Table I. Examples of performance measurement standards relative to different aspects of the direction-setting process.

Objectives	Strategic Programs	Strategic Budgets	Operational Budgets
Market share	Ability to cope with competitors response	Strategic Budget Spending	Responsibility Center Performance
Sales growth rate	Customers response	—Per Organizations entity involved	—Cost —Sales
Rate of new products compared to total introduced over last 2 (5) years	Other stakeholders response Technological breakthroughs of others Completion of milestones in specific strategic programs	—Per strategic program task Time spent by key managers on strategy implementation tasks	—Profit —ROI, ROE

differ across these four process dimensions. A partial list of standards that might be used to establish a manager's incentives appears in Table 1.

While it is clear that different incentive standards are required for each of the four strategic tasks outlined in Figure 1, it is less obvious that these measures must also be interrelated. There are two primary aspects to this interrelationship. First, there must be consistency between the incentive standards that apply along all four dimensions. Each dimension does, after all, reflect aspects of a single underlying strategy. Therefore, standards for an individual's contribution to objective setting, strategic programs, and strategic and operating budgets must be conceived in such a way that they are mutually reinforcing. Second, performance deviations with respect to one dimension must be reconcilable with the measurements of performance along the other dimensions. Incentives can only be meaningfully allotted by interpreting the four types of performance signals together. In developing strategically focused management incentives, it is therefore critical that the performance criteria for each manager be devised as a "vector" in which the four strategic performance dimensions are all incorporated to ensure consistency with the strategy each manager is pursuing.

INCENTIVES BASED ON VARIANCES vs DECISION PREMISE IMPROVEMENT

From Figure 1 we can deduce that there are, in fact, two broad types of incentives that will be at work. First, when devising incentives to

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fulfill the budget, emphasis will be on the extent to which actual budgetary targets have been met. By means of the control process we determine whether there is a positive variance between planned and actual results. Positive incentives are typically provided for positive variances; negative incentives might be allotted to negative variances. We shall call this type of incentive *variance-based incentive*. Examining Figure 1 more carefully, we find that the concept of variance-based incentives has somewhat less relevance when we move away from near-term budgetary performance applications and consider, say, how it would apply to the objectives-setting stage. The problem we encounter here is that objectives and, for that matter, strategic programs typically require a long time for implementation. As such, the concept of assessing the difference between planned versus actual performance might be difficult to operationalize due to the long time-horizon needed for control (see Dearden, 1962). We would expect objectives and strategic programs to change over time and, indeed, they are almost never implemented in the exact way they were originally formulated. This time problem horizon issue therefore poses a fundamental difficulty for the application of variance-based control. For successful strategy implementation, however, it may be even more important to provide management with another type of incentive, namely an incentive to respond to changes in underlying critical factors, i.e., for deciding, when and how to take decisions to modify initial objectives or strategic programs in the light of new circumstances. Thus, we shall propose another type of incentive that we shall label *decision-premise-improvement incentives*, based on how well management responds to changes in environmental circumstances. This type of incentive is more applicable to the "front end" of the direction-setting process, whereas variance-based incentives are more applicable when related to the "back end" of the direction-setting process. The relative emphasis on one type of incentives versus the other shifts as we move from one phase of the direction-setting process to the other.

The proportion of relative emphasis between the two forms of incentives will of course also differ depending on the particular strategic setting in which a manager operates. For instance, contrast how these patterns might differ when applied to a new start-up, high-growth business as opposed to a well established, mature, resource-generating business. For the former, a relatively heavy emphasis should be placed on decision-update incentives through all direction-setting stages, for frequent changes will have to be made in this new business strategy because of rapidly changing environmental circumstances. The left panel of Figure 2 indicates this. For the mature business, however, there should be relatively more emphasis on variance-based incentives throughout, given that the basic way of doing business normally is often relatively clear in such strategic settings and that emphasis should be on achieving output. The tradeoff-line in Figure 2 illustrates this.

The importance of management tailoring of the incentives process is

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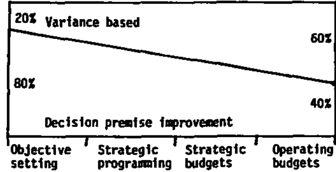

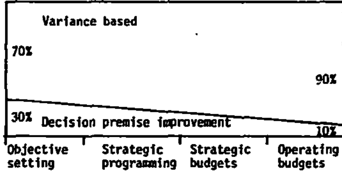

Figure 2. Shifts in relative emphasis between decision-premise-improvement incentives and variance-based incentives across the various stages of decision, setting for (a) start-up, high-growth businesses and (b) well-established, resource-generating businesses.

obvious. From our discussion of strategically focused incentives, tailoring is critical if management is to have a flexible system that can be applied to each particular business. What might be a valid measurement of strategic progress for one business may be inappropriate for another. For a new start-up business, as we have seen, relatively more emphasis might be put on providing incentives for increasing market share than would be the case for more mature businesses, where incentives to enhance efficiency and profitability might be relatively more important. It is thus crucial that management focus its incentive approach for a particular strategic business unit on a few performance factors that are tailormade to its strategy. Also, management's incentive-setting approach should focus on feedback regarding the progress of the few uniquely important strategic programs that the firm pursues. Management's incentives should not only include broad generalized strategic program incentives based on time and resource expenditure, but should also give management credit for its ability to analyze reactions from the environment to a particular key strategic program. A final tailormaking consideration applies to incentives for fulfilling the strategic budgets. Management must make sure that high-growth start-up businesses, i.e., strategic entities which require investment for the accumulation of future strategic strength, are provided with sufficient strategic budgets. The fulfillment of a strategic budget should be given large weight in such instances. For mature businesses, on the other hand, strategic budget fulfillment should be given considerably less weight in the setting of incentives; in fact, the significance of the strategic budget should be quite minimal in this context compared to the importance of the operating budget. This typology therefore requires the tailoring of budgetary performance so that it reflects the strategy at hand. Deft handling of the relative emphasis on strategic budgetary performance versus operating budgetary performance is the key.

Thus far we have addressed the need to maintain strategy/human resource system consistency across the four strategic direction-setting *stages* and across the three strategic *levels* of the firm. It is equally critical, how-

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ever, that the planning and human resource executives charged with the design and administration of these systems view this issue in the same way. In other words, there must be a commonality of perception regarding the meaning of strategy/human resource system consistency across these two *functions*. It often happens that the planning and human resource staff groups *do not* share such a common understanding of the integrated nature of these systems. To illustrate, our empirical survey study alluded to above found that at the business element level, the human resource executives interviewed expressed much greater satisfaction with their firm's management selection procedures than their counterparts in planning, while at the corporate level, these perceptions reversed completely (see Lorange and Murphy, 1983). It appears that human resource executives have relatively less impact on management selection processes at the corporate level than they do at the business element level, and this divergence may reflect their sense of relative participation in these processes across the levels of the firm. The same, of course, could be said of planners who often spend large amounts of time with top management but relatively less time with business element managers. By adopting a parochial view and "protecting" their respective parts of the system, these two types of staff managers can cause a deep dysfunctionality in the operation of the overall management system of the firm.

INCENTIVES BASED ON DIRECT RESPONSIBILITY vs INDIRECT RESPONSIBILITY

We have so far discussed strategic incentives as they apply to a particular strategy and have used examples from the business strategy level. In this section we shall consider the strategic incentive setting tasks relative to the corporation as a whole. In particular, we shall address top management's direct role in providing incentives to facilitate execution of the portfolio strategy.

As the major custodian of the overall corporate portfolio strategy, top management needs to be intimately involved in providing incentives to enhance the overall progress of this strategy. We shall describe two aspects of setting incentives for upper level managers—incentives stemming from those aspects of their job in which they are *directly* responsible for acting and incentives stemming from the performance of their underlings for which they are *indirectly* responsible.

The first type of incentives, when seen in the context of a CEO, focuses on how the corporate portfolio strategy (or a business family strategy when seen in the context of a division manager) is affected by changes in critical external phenomena, such as economic recession, interest rates, inflation, the stock market's movements, the political situation, etc. The key issue is top management's contribution to coping with these factors.

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We shall call this sphere of activities top management's *direct* responsibility, and a part of its strategic incentives.

As noted, however, the portfolio strategy (or a business family strategy) is also significantly affected by the performance of the various underlying business family/business element strategies that in aggregation make up the firm. Thus, top management needs to accept the responsibility, at least to some ext[illegible] the performance progress of each of these strategies. We shall de[illegible] the incentives that top management receives for enhancing such performance as based on its *indirect* strategic responsibility. The incentives stemming from direct and indirect performance responsibility are of course interrelated. It goes without saying that in a large, complex organization the setting of incentives can become quite complicated.

We will now discuss some of the difficulties related to the challenge of designing an appropriate hierarchical, strategically driven management incentives system for top management. One should keep in mind that top management will need to be attentive to the provision of strategic incentives at not only the corporate-wide portfolio level but also at the business family and business element levels. Clearly, they cannot directly control all these strategies. However, given that a change in a lower level strategy is likely to affect some or all higher level strategies, or *vice versa*, it is clear that top management should have *some* involvement in setting the strategic incentives at all strategic levels.

To illustrate, a change in a critical environmental assumption affecting a business element strategy (e.g., a competitor's announcement of a new product based on a new and radically different technology) will not only have an impact on the particular business element strategy as such. The business family strategy, of which the particular business element is synergistically a part, may also require revision. Rather than enhancing the state-of-the-art technological image of the other business elements within the family, the business element in question may now become an "embarrassment" to the others in the marketplace. A revision of the family's strategy, creating "distance" between the now technologically lagging business and the others, might be appropriate. Another tactic might be a diversion of strategic resources into R&D to catch up or even "leapfrog" back into the technological forefront in the embattled business.

Hence there will be tangible effects on the corporate portfolio strategy level. First, resources may have to be rechanneled. These resources normally have to be withdrawn from other applications, and this withdrawal will, in turn, require changes in other business family/element strategies as well. Second, the stability of one of the "building blocks" of the portfolio has been shaken. This might result in a dimunition of the expected strategic resource flows from this business, as well as a potential delay of the arrival of positive resource contributions. It may also require a change in the overall economic risk exposure assessment. Thus, the corporate portfolio strategy may have to be revised. Management's incentives should

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be modified so as to reflect these new strategic realities. It is critical that the incentive system should facilitate, not hamper, such adjustments.

While top management should not be actively involved in the "nitty-gritty" of developing the strategic incentives system to cope with the multilevel monitoring challenges illustrated in the previous paragraph, we shall claim that top management must have a clear basic conceptual understanding of the nature of the task to appreciate and make effective use of a tailormade strategic incentive system. We shall therefore present a sketch of such a multistrategy hierarchical strategic incentive system. We will take as a departure point for our discussion the business element level, and then build additional strategic level incentives upon it. This pyramid approach will illustrate the "dovetailed," cumulative nature of top management's incentives-setting task at the portfolio level.

Table II illustrates the strategic incentives process at the business element (BE) strategy level. This is analagous to Figure 1 in that the strategic incentive task of *one* strategy can be broken down into four interrelated aspects: monitoring the continued relevance of the major assumptions behind the objective (BEO); monitoring the progress of the key strategic programs (BESP) (both in terms of actual physical progress and in terms of changes in critical underlying factors); monitoring the day-to-day activities to implement strategic programs as reflected in resource expenditures versus the strategic budget (BESB); and finally, monitoring budgetary responsibility center operating performance (BEOB).

There may be a need to revise the initial strategic targets and to initiate

Table II. Strategic incentives at the business element level (BE) responding to changes in critical factors directly applicable to the business element strategy.

Revisions in Strategic Incentive Targets	BEO′	BESP′	BESB′	BEOB′
Corrective Actions	No/Yes ⟷ ↑	No/Yes ⟷ ↑	No/Yes ⟷ ↑	No/Yes ↑
Critical factors directly affecting strategic incentives at this strategy level	Business attractiveness Competitive strength	Competitor's response Customers' acceptance Technological shifts Program progress	Strategic resources: —Funds —People/time	Operating performance targets: —ROI —Profit —Sales —Costs
Initial strategic incentive targets	BEO	BESB	BESB	BEOB
Stages of strategic direction	Objectives-setting	Strategic programs	Strategic budgets	Operating budgets

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corrective actions for two reasons. First, we may have to change an initial strategic target due to subsequent changes in one or more of the critical underlying factors that directly apply. This circumstance is indicated by the upward-pointing vertical arrows in Table II. Table II also indicates some common types of critical underlying factors that might apply. (For more elaborate sets of such factors, see Table I.)

Second, there may be a need to change a more general directional target, such as an objective, due to changes in a more specific directional target, such as a strategic budget, or vice versa. This eventuality is indicated by the dotted horizontal arrows. For instance, a drop in operating performance *may* (or may not) lead to an adjustment of the amount of resources that can be allocated in the strategic budget and may also lead to a reprioritizing among the strategic programs. The result of these control activities, which the managers at the business element level in the organization carry out, will be a change in one or more of the original strategic targets, the revised targets being (BEO′), (BESP′), (BESB′), and/or (BEOB′), respectively.

Table III illustrates the strategic incentive process at the business family

Table III. Strategic incentives at the business family level (BF)—responding to changes in critical factors directly applicable to the business family strategy as well as to indirect effects from changes in underlying business element strategies.

Revisions in strategic incentives targets	BFO′	BFSP′	BFSB′	BFOB′
	↓	↓		
Corrective Actions	No/Yes ⟷	No/Yes ⟷	No/Yes ⟷	No/Yes
Lower level revisions in strategic incentives changes?	BEO′(?) ↑	BESP′(?) ↑	BESB′(?) ↑	BEOB′(?) ↑
Critical factors directly affecting strategic incentives at this strategic level	External synergies Internal synergies	Competitor's response Customer's acceptance Efficiency/technology Program progress	Strategic resources spent	Operating performance
Initial strategic incentives targets	BFO	BFSP	BFSB	BFOB
Stages of strategic direction	Objectives setting	Strategic programs	Strategic budgets	Operating budgets

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(BF) level. Several aspects of the strategic incentive process for the business family are similar in concept to those just discussed for the business element level. The initial business family objectives (BFO), strategic programs (BFSP), strategic budgets (BFSB), or operating budgets (BFOB) may be modified due to changes in critical factors that directly apply to this strategy; this again is indicated by vertical arrows. Table III defines these classes of critical factors. Once more, we may also have modifications that stem from changes in one or more of the other three directional targets at this strategic level, as indicated by the dotted horizontal arrows. Finally, we may have a need to make changes in targets at the business family strategic level due to the effects of changes at the lower business element strategy level, i.e., from (BEO′), (BESP′), (BESB′), and/or (BEOB′). This circumstance is also indicated by vertical dotted arrows in Table III. The result may be changes in one or more of the initial directional statements at the business family level, i.e., (BFO′), (BFSP′), (BFSB′), and/or (BFOB′).

Table IV finally gives a picture of the strategic incentive task at the portfolio level, reflecting the part of the firms′ incentive activities that the CEO will manage directly. As was the case for the business family level, the original portfolio objective (PO), strategic programs (PSP), strategic budget (PSB), and/or operating budget (POB) may have to be changed due to effects from one or more of three sources: direct changes

Table IV. Strategic incentives at the corporate portfolio level (P)—responding to changes in critical factors directly applicable to the portfolio strategy as well as indirect effects from changes in underlying business family strategies and/or underlying business element strategies.

Revisions in strategic targets	PO′	PSP′	PSB′	POB′
Corrective actions	No/Yes	No/Yes	No/Yes	No/Yes
Lower level strategy changes?	BFO′(?) BEO′(?)	BFSP′(?) BESP′(?)	BFSB′(?) BESB′(?)	BFOB′(?) BEOB′(?)
Critical factors to directly control for this strategy level	Debt service Dividend service Economic risk Political risk	Divestitures Acquisitions Corporate R&D/venturing	Resources spent	Operating performance
Initial strategic targets	PO	PSP	PSB	POB
Stages of strategic direction	Objectives setting	Strategic programs	Strategic budgets	Operating budgets

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in critical assumptions behind the portfolio strategy (see Table IV for examples of such critical success factors), changes stemming from one or more of the other three types of directional statements at the corporate level, and/or changes stemming from modifications of strategic direction at the lower business family level or even at the business element level.

The discussion of this multilevel strategic incentive approach highlights several important principles for how top management can achieve an effective method for providing strategic incentives. Perhaps the most important consideration is the realization that top management's incentive task involves a *combination* of incentives stemming from their direct involvement in managing the portfolio strategy as well as incentives stemming from their indirect responsibility for the underlying lower level strategies. At the business element level, the strategic incentive task was based on direct responsibility only, since for a manager of a business element strategy the only factors that can affect his strategy directly are the critical factors noted in Table III. In contrast, a significant fraction of the portfolio level incentives is based on indirect responsibility, while some fraction of incentives at the business family level is indirect due to impacts from the business element level.

A TAILORMADE PERFORMANCE EVALUATION FUNCTION

An individual manager's incentives and the basis for his expected performance should hence be determined by both the strategic and operating roles he is playing. The relative preponderance of one role over the other should dictate the relative balance between his decision-premise-improvement incentives and his variance-based incentives. Further, his position in the organizational hierarchy should dictate the relative proportions of incentives based on direct performance responsibility (high at lower hierarchical levels) versus those based on indirect performance responsibility (high at upper hierarchical levels). A manager should thus have a multidimensional performance function that is tailormade for him. It should reflect specific expectations on the following items:

Direct responsibility:

- for objectives fulfillment (primarily decision-premise improvement)
- for strategic program fulfillment (primarily decision-premise improvement)
- for strategic budget fulfillment (primarily decision-premise improvement)
- for operating budget fulfillment (primarily variance based)

plus

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Indirect responsibility:

- for objectives fulfillment (primarily decision-premise improvement)
- for strategic program fulfillment (primarily decision-premise improvement)
- for strategic budget fulfillment (primarily decision-premise improvement)
- for operating budget fulfillment (primarily variance based)

Standard MBO-type procedures should be followed in the setting of incentives as well as for the *post facto* evaluation of a manager's actual performance along these dimensions (see, for instance, Carroll and Tosi, 1973). Two points should be stressed regarding the working of this approach: First, upper management must be prepared to involve themselves in a real sense in the negotiation of each key manager's objectives and in the follow-up evaluations of performance. Thus, the interactive dimension is critical in making the process work. Participants in this process should also be aware that the assessment in question contains a significant element of subjectivity. Second, the particular manager in question should get a clear and unambiguous idea of the more critical performance aspects he should emphasize. This means, in other words, that an individual manager must be clear in his own mind as to the relative importance of the various performance factors in question, so that he can make a "practical translation" of these considerations in his own activity pattern.

One final general observation should be made regarding the delineation of a comprehensive strategic incentive system if it is to be of use to top management: the overall logic of the approach must be clear. We are dealing with a complicated, interrelated, multivariate set of phenomena, with a large number of executives, tracking a multitude of variables. It is therefore imperative that top management be able to comprehend the general logic and structure of the system to facilitate choices such as who should be involved in tracking what variables, when they should bring up deviations, etc. For this reason, too, it is important to spell out the pattern of multilevel interrelationships required for tracking critical factors.

PROBLEMS IN THE DELINEATION OF STRATEGIC PERFORMANCE CRITERIA

As already noted, there is a logical interrelationship between the formulation of strategic plans for establishing the firm's direction, monitoring and evaluation of the achievement of actual performance, and the provision for incentive compensation, as depicted in Table I. We see from that table that the direction-setting process has been punctuated into four interrelated phases, objectives-setting, strategic programming, and

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strategic and operating budgeting. In this section we shall discuss in more detail some of the performance measurement problems associated with this kind of direction-setting model. Recognition of these types of measurement problems and attempts at their amelioration are an important step towards the integration of human resource management into the strategic process.

Let us first briefly examine budgetary control's role as a vehicle for the monitoring of strategic progress. At the outset we shall need to state in this context that budget-based performance evaluation plays a major role in monitoring most large organizations' performance progress. What, however, are some potential problems or dysfunctional effects that arise in using budgetary control as *the* major mode for monitoring strategic progress, and as the primary basis for awarding measurement incentives?

One potential problem stems from the predominantly internal focus of budgetary control. Deviations between actual performance and preset standards are measured, but do not provide much insight regarding whether underlying environmental factors might have changed, thereby affecting performance of the firm at this or a later stage. Also, performance is typically measured around organizational entities within the firm which have been charged with carrying out specific tasks, these entities typically being cost centers, revenue centers, or profit centers. However, these organizational entities do *not* necessarily reflect the strategic environment that the firm is facing. Moreover, the firm often tends to be highly fragmented into many, relatively small, responsibility centers, making it frequently difficult for upper management to maintain a meaningful overall picture of progress. A careful redefinition of organizational entities into business elements and business families might thus have to be undertaken to provide a basis for performance measurement that is strategically driven. However, units of operating budget measurement tend to be internally, not strategically, focused.

A related problem when using budgetary control as a measurement of strategic progress stems from the *delayed* signals often received. Environmental factors, such as shifts in competitive climate or changes in the firm's growth rate, may show up in budgetary deviations so late that valuable time to take ameliorating actions may have been lost.

A third problem with budgetary control lies in the assumption that the budget indeed is adequately linked to the strategic plan. Often, however, this may not be the case. Many budgets are formed as a consequence of past activity level patterns, incremented by a certain "percentage update" each year, and are thus *not* explicit reflections of the strategies. To base performance on such historically derived performance standards might be risky.

There are other potential deficiencies in utilizing operating budget performance as a major determinant for executive incentives. Fundamentally, even if we were willing to assume that the operating perfor-

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mance measurement problems were negligible, a short-term performance bias could easily result. Above all, confronting more fundamental strategic problems with longer term implications might not receive the priority it deserves from a key executive. We have already touched upon the potential dangers of such short-term performance emphasis, and this issue has also received widespread attention elsewhere (see, for instance, Abernathy and Hayes, 1980); hence, we shall not pursue this further here.

Lack of confidence in the measurements of operating performance will of course add to the feeling among managers that such performance measurements might not necessarily reflect meaningful managerial contribution towards performance. Because of this, they may not feel sufficiently motivated by these types of performance measurements.

Even though we are definitely not proposing unilateral emphasis on operating budgetary control as a major basis for management incentives, there should of course be some emphasis on this performance dimension. What, therefore, are some of the steps that might be taken to strengthen operating budgetary control as a vehicle for assessing strategic performance? Although the purpose of this article is not to discuss how to develop better budgets, we shall briefly point out some areas that might strengthen the usefulness of the budgeting process.

First, there should be an explicit split between what we shall denote strategic and operating budgets. The strategic budget is intended to reflect the specific aspects of the agreed-upon strategic programs to be carried out over the coming budgetary period. This should articulate the resources needed to carry out these programs, in terms of human resource wages, other expenditures, investments and additional working capital requirements. Each organizational entity which is involved in implementing strategic programs, normally through one or more team roles, will thus have its strategic budget for these purposes. These budgets will thus be directly derived from the prevailing strategies of the firm. Second, performance monitoring should be carried out in parallel for the strategic and the operating budgets, thereby giving separate insights regarding strategic and operating performance (see Haggerty; Lorange and Vancil).

Let us now turn to a brief examination of the annual (typically) five-year planning process as a vehicle for assessing strategic performance. One problem is that the very nature of this activity calls for a periodic measurement of the five-year plan, but only once a year. Thus, unless revised during the year the plan will quickly run the risk of becoming out of date, and consequently will no longer be a good standard against which to measure performance. Another problem with many five-year plans is that they frequently become exceedingly bureaucratic in nature. Also, as was the case for budgets, the plans too might become extrapolative, projecting the past, rather than being focused on the emerging environmental realities. (See Figure 2.)

There are of course several ways to strengthen the annual long-range

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planning effort so that it also can become a better standard against which to base performance evaluation. One would be to strengthen the measurement of critical environmental assumptions as part of the strategic process. We shall return to this shortly in another related context. Another approach is to track changes in strategic positions more specifically, particularly to shed light on shifts in one's competitive strength as well as in the attractiveness of the business. Such activities might facilitate more realistic and relevant strategic plans, and thus provide a better basis for the evaluation of strategic plans, and thus provide a better basis for the evaluation of strategic progress and a basis for strategy-derived compensation.

Let us turn to a related aspect of monitoring strategic progress, namely the monitoring of the degree to which strategic budgets or "milestones" are being achieved. Assuming of course that the underlying plan from which the strategic targets are derived is relevant, it can be a useful supplement to budgetary performance evaluation to assess the pattern of success in "milestone" completion. There may be potential problems with this approach too, however. One might be that the milestone targets or performance standards are set so far into the future that they tell us little about performance during more near-term periods. For instance, to assess whether a particular planning milestone has been reached or not five years after it has been set tells us little about performance in each of the intermediate years. Another problem might be the lack of ability to understand why a particular strategic target has not been met. How, for instance, can milestone deviations be reconciled with other performance deviation measures, such as budget deviations? Keeping in mind that a strategic program for reaching a milestone is typically a cooperative team effort of several organizational entities, how then can responsibility for missing a milestone target be assigned?

There are several steps that can be taken to circumvent these problems. One would be to "punctuate" a strategic program in such a way that meaningful "sub-milestones" can be established. Efforts will of course also have to be made in this context to check the continued relevance of the underlying strategy. Another way to strengthen milestone monitoring will be to explicitly link the monitoring of strategic programs and strategic budgets (see Lorange and Vancil, 1977; Lorange, 1983). Each strategic program is monitored "horizontally," while each strategic budget is broken down into separate components, each relating to specific strategic programs, will be monitored vertically (see Figure 2).

For a particular strategic program, then, one can assess the extent to which each organizational entity which is supposed to participate is in fact carrying out its share of the team task. Thus, failure to meet a milestone might at least in part be related back to a particular team unit. For each organizational entity also, one can assess the extent to which each of the particular strategic program team-tasks assigned to it are being carried out. One can thereby assess whether in fact an organizational

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entity is spending its efforts on pet projects and neglecting others, while still fulfilling its strategic budget on the aggregate.

Let us now turn to a final aspect of how to strengthen measurement standards and thereby achieve a better perception of strategic progress. This aspect concerns the monitoring of critical environmental assumptions to which we have already alluded. By keeping a watchful eye on changes in critical environmental factors one might be in a better position to understand performance deviations and to react meaningfully to new strategic threats and opportunities. There are, however, difficulties with this approach too. One such problem might be that the environmental phenomena are not closely associated with a given strategy, i.e., they are not sufficiently articulated to allow for understanding of how shifts in such factors might affect the strategy. Lack of specificity in the measurement of these factors might also detract from their usefulness in providing updated and improved performance standards.

In terms of approaches for overcoming these problems, several types of improvements can be made. First, an attempt at groping for a deeper understanding of the interrelationships between environmental factors and one's objective should be made. In this way, a "theory" can be developed, which focuses on a set of a few truly significant environmental factors and their interrelationships. The meaning of environmental factor variations can thus be better understood. Second, the questions of predictability and response options *vis-a-vis* particular environmental factors should be explored, for at least two reasons. On the one hand, if a critical factor is random, i.e., cannot be understood or predicted, then it is of course difficult to relate managerial performance to the aspects of an objective's fulfillment that this factor affects. Thus, positive as well as negative performance effects from such random occurrances should be accounted for.

On the other hand, by examining one's ability to respond to a particular factor ahead of time, one can become more sensitive to the amount of discretion management might have for coping with this phenomenon. Incentives should not be alloted only on the basis of attainment of an output level, but also based on how well a manager is able to respond to a particular challenge. Thus, more explicit understanding regarding the nature of the response options might help management give proper credits regarding such managerial actions.

The preceding discussion has illustrated the need to examine the performance standards carefully in developing strategically driven human resource management and managerial incentives. A basic requirement for good incentives systems is the need to understand how to set performance standards that are strategically meaningful and to meaningfully interpret progress on each of these performance standards. Thus, as one critical step towards making managerial incentives more strategically attuned, there should be a call for the establishment of several performance standard criteria and for measuring the progress along several dimensions.

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BARRIERS TO STRATEGIC INCENTIVE SETTING

Thus far, our discussion has focused upon the presentation of a conceptual scheme for incorporating management incentives into the overall strategic planning process of the firm. Without doubt, a sound conceptual approach is an indispensable prerequisite for effective strategic incentive setting; however, solid conceptual constructs alone do not guarantee successful implementation. Several types of barriers can rise within the firm that can inhibit or even prevent the forging of effective links between the management incentive and corporate planning systems. In what follows, we will discuss systemic, behavioral, and political barriers to effective strategic incentive setting that can arise at each of the firm's three levels of strategy. We will illustrate most of these problems with quotes drawn from our survey data base.

Business Element Level

A major systemic difficulty that many firms today confront is the inability to develop serviceable criteria for assessing the *long-term* performance of individual business element managers. This problem is especially acute in high growth, high technology companies. One pharmaceutical executive, for example, summarized his firm's difficulties in this area as follows: "We're totally derelict here. We do not tie in success as the long range plan to the business plan. The links are bad. Our rapid turnover at this level further complicates the measurement of a manager's long-term success." In high growth companies, therefore, the need to move talented managers up the ranks quickly renders any meaningful assessment of long term performance problematic.

On the behavioral level, many business element managers resist assignment to cash-cow businesses. For such executives, a cash-cow assignment is a sign that they have fallen out of favor with top management. A planner from the food industry was quite explicit on this point: "We find it difficult to keep good cash-cow managers interested in cash cows. While this is less of a problem with Europeans, Americans often regard cash-cow assignments as tantamount to relegation to the backroom. The tragedy is that the very executives who are best suited to cash-cow management often feel this way." This type of attitude obviously represents a formidable obstacle to the development of rational executive assignment and promotion practices. It indicates that strategic thinking is not well understood at lower management levels.

Politically, incentive systems can suffer from a perceived arbitrariness in their operation. It is often difficult to decide who should get the credit (blame) for a particular favorable (unfavorable) development; and if prior consensus on the method of allocating incentives is not achieved, the incentive systems can become a major source of internal friction within the firm.

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Business Family Level

Above we hypothesized that a policy of intradivisional management rotation would be useful to foster a spirit of team work at the business family level. Without this spirit of cooperation, we argued, it would be difficult to realize all the potential synergies that can become available to a business family. While many of the executives we interviewed endorsed this proposition, several respondents from high technology companies expressed a different opinion. Specifically, they argued that the scientific specialization of their products, even of those grouped within the same families, had progressed to the point that there were now real diseconomies involved in rotating a manager out of a product he had learned well. As one electronics executive put it: "We used to rotate managers around within the same sector quite routinely. This policy is on the wane. Our businesses now require very specialized knowledge of products and markets and we believe that too much turnover would lead to real inefficiencies." Similarly, a pharmaceutical executive noted: "The days of 'a manager is a manager' are over. We like to keep them specialized." While the rationale behind this approach is comprehensible it raises structural problems for the design of strategic incentive systems. Can a resource still be considered *strategic* if it can no longer be readily reallocated or redeployed within the firm? What implications does this new managerial immobility raise for strategic human resource planning?

From a behavioral perspective, we have observed that even among companies where it appears possible, intrasectoral rotation of managers is not used to its full advantage. We have already alluded to the reluctance of many managers at the business element level to accept cash-cow assignments. A standing policy of intrasectoral rotation could help remove the feeling of exile from the corporate mainstream that afflicts many cash cow managers. Such a policy could thus raise the level of strategic consciousness among managers but it is seldom used to this end.

Political problems may arise at the business family level with managers who resist reassignment because they have an excessively parochial view of their roles and functions. A manager who has held his present position over a period of years may develop stronger loyalty to this own "kingdom" than to the firm as a whole. The temptation to err in this direction may be especially strong when the manager has been associated with the firm's "flagship" element or family. In this case, we confront a different kind of self-imposed resource immobility.

Corporate/Portfolio Level

At the corporate level, there appear to be three primary systemic barriers to effective strategic human resource management. In the area of executive assignment/promotion, there is often a lack of congruence between the skills needed to succeed as a business family manager and the skills

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required for success as a senior level general manager. This fact greatly complicates the design of rational executive selection procedures. As one electronics executive told us: "Success at the business family level is a poor predictor of success at the general management level. Many people who would make excellent general managers never get the chance because they fail at the business family level and we lose sight of the fact that different skills are required." These sentiments were echoed by a pharmaceutical executive: "A good general manager must be able to delegate and he must be able to make major decisions with insufficient data. A good business family manager can succeed without possessing either of these qualities".

Another major systemic barrier to effective management selection procedures at the corporate level is the lack of a corporate wide perspective among the candidates for general management positions. "Parochialism is a real danger," an electronics industry executive stressed to us. "Many of the candidates for these jobs have grown up in one line of business and have lost sight of the whole. They have no corporate viewpoint and they must develop one on the job and that is very inefficient." Above we pointed out the new willingness of many high technology companies to leave gifted managers in charge of narrowly specialized scientific products for long periods. Such a policy will surely exacerbate the problem of parochial outlook among the general management candidate pool.

The third major systemic problem—and it is a particularly vexing one—is the lack of meaningful measurement techniques for calibrating incentive awards at the corporate level. As one of our respondents phrased it: "It's very hard to isolate the precise contribution of any one general manager to the portfolio development of the firm".

Along the behavioral dimension, executive "entrapment" at the corporate level is a major barrier to the design of effective strategic incentives (Brickner). Often an individual senior manager or group of senior managers will find that they have lost the ability to reassess the continued relevance of a strategy they are closely associated with. Unless the incentive system makes an explicit attempt to grapple with this kind of "group think", its effectiveness will certainly suffer.

The primary political barrier at the corporate level is the failure of the senior planner and the senior human resource executive to share a common outlook on the role and function of the incentive system. As we have already noted, a lack of congruent perceptions here raises serious "system design" issues and may also imply a deep seated dysfunctionality in the firm's over-all management system.

Thus far, we have presented a conceptual scheme for the design of strategic incentive systems, discussed problems in the development of executive performance criteria, and listed various types of systemic, behavioral and political barriers to the design and implementation of effective strategic incentive systems. We will now present some suggestions for further research within this field and discuss certain implications for practicing managers.

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There are at least three broad areas in which more research is definitely needed.

The first area concerns the tailoring of the incentive system. In our previous discussion, we noted the importance of tailoring the incentive system to the current position of the business in the strategy cycle, i.e., according to whether it is a newly emerging business or a mature one. But tailoring is surely a more complex, multidimensional process. It is also important to tailor incentives to the marcoeconomic conditions anticipated over medium term. One electronics executive, in fact, commented to us: "We need managers at the business element level who can manage through an adverse economic cycle. After all, even growth businesses have down periods." The industrial environment in which the firm operates may also have to be considered in the tailoring process. Can we, for example, develop any general guiding principles to aid the design of incentive systems for high technology companies versus heavy industrial or service companies? Throughout this paper, we have drawn attention to the problems that high technology companies face in this area (e.g., the trend towards managerial development through depth rather than breadth). Heavy industrial and service enterprises likewise face problems unique to their industrial settings. A typology developed along industrial as well as strategy cycle lines would be very helpful here.

Second, the whole area of measurement standards and performance criteria sorely needs more systematic study. The vast majority of companies in our survey sample felt that they were floundering in their attempts to develop serviceable long range performance criteria for their managers. There is not even any consensus on whether such long term criteria should be quantitative or qualitative or some mixture of both. Given the perceived failures of American industry's "short-term" outlook, the design of effective incentives for long range performance should assume a central place in any future research agenda for this area.

A final set of research issues revolves around the roles of the various staff functions involved in the design of strategic incentive processes. Specifically, what should the relative roles of the planner versus the senior human resource executive be with respect to this issue? What should be the nature of the interaction of these two executives in the delineation of variables to measure performance on strategic programs, strategic budgets, and operating budgets? As we have noted, the planner and senior human resource officer in many firms have managed opposite sides of the same coin. How can a more unified perspective be brought to bear on the incentives problem? How can "turf fights" be avoided? How can the incentive setting process be strengthened over time?

We will now discuss some of the implications of our study for practicing managers.

The first point is that planning and human resource management are both key parts of the overall management system of the firm. Hence, they must be carefully coordinated so that they reenforce each other.

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Traditionally, human resource managers have not played an active role in the planning process at most firms. Consider, for example, the comments of a human resource manager from our data base: "Generally, the human resource function at this firm has had to provide very short-run, tangible services at the business element level. It has been a real problem for us to try to view human resource issues at this level from a strategic perspective. We've only been doing this here for two years." Such a situation should be, and is now, changing at many companies, but the integration process requires close cooperation among all concerned. The difficulties involved in inducing human resource executives to think strategically and, conversely, in inducing planners to be more mindful of human resource concerns should not be underestimated.

Second, most managements place disproportionate emphasis on the articulation and elaboration of strategic plans and give short shrift to the human resource dimension of the planning process. We would argue that the effectiveness of, and benefits from, the overall process are only as good as its weakest link. There is thus a clear need for additional emphasis on strategic human resource management in the future.

Peter Lorange, D.B.A., Harvard Business School, is Professor of Management at the Wharton School, University of Pennsylvania. He previously taught at the Sloan School of Management, MIT, and the IMEDE Management Development Institute, Lausanne, Switzerland. He is a member of the American Accounting Association, Operations Research Society of America, and the Institute of Management Science. He has authored or co-authored Behavioral Factors in Capital Budgeting, Strategic Planning Systems, Corporate Planning: An Executive Viewpoint, *and* Implementation of Strategic Planning.

Declan C. Murphy is a Ph.D. candidate at Princeton University and holds an M.B.A. from the Wharton School, University of Pennsylvania. He has been a consultant to Hoffman-LaRoche, Inc. and the U.S. Department of Energy. He is currently a lecturer in the Department of Management, the Wharton School.

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