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ABSTRACT

This paper argues that strategic choice behavior and subsequent performance can be determined in part by "reference points" which are consciously or unconsciously adopted by decision makers. Building upon prospect theory and other relevant theoretical perspectives, the concept of the Strategic Reference Point (SRP) is developed. A firm's SRP consists of three dimensions: internal capability, external conditions, and time. Taken together, these three dimensions and their associated elements capture the structure of the organization's strategic mission and vision. The theory 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. It thus appears that managers can utilize the concept of the SRP to motivate an organization to seek or accept strategic change.

The rational model of strategic choice has been questioned extensively. A well-established behavioral literature demonstrates that individual cognitive limits, organizational politics, and environmental change all serve to blunt rational choice (March and Simon, 1958; Lindblom, 1959; Tversky and Kahneman, 1974; Lyles and Mitroff, 1980). At best, according to this literature, individuals and organizations can achieve only "bounded rationality" (Simon, 1957). For top managers, this means that the formulation of a deliberate or comprehensive strategy is an illusion (Mintzberg, 1978; Mintzberg, 1990). However, abdicating responsibility for strategic choice by allowing it to emerge from the bottom-up is probabably not desirable either (Guth and MacMillan, 1986).

Given the infeasibility of the former and undesireability of the latter, what is the appropriate role for top managers in strategic choice? Can managers make a difference? In particular, can managers alter the perceived risk-return position of organizations? Quinn (1978) proposed that rather than seeking to be comprehensive-- the ideal of rationality-- executives instead should work to create a broad sense of direction, but allow the precise nature of the strategy to emerge over time. Hart (1992) described this as the "symbolic" mode of strategy-making where executives attend primarily to crafting an ambitious mission and creating a compelling vision which helps focus the actions of organizational members. Such a vision or "strategic intent" should serve to inspire and motivate organizational members by creating a high level of aspiration (Westley and Mintzberg, 1989; Hamel and Prahalad, 1989). Economic and organization theory have also recognized the importance of establishing targets or reference groups (and, by implication, "gaps" and "aspiration levels") for individual and organizational performance. Indeed, industrial economics (Porter, 1980), resource dependence (Pfeffer and Salancik, 1978), and institutional 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. Similarly, motivation theory (Latham and Yukl, 1975), prospect theory (Tversky and Kahneman, 1981), and the resource-based view of the firm (Barney, 1989) each emphasize the importance of *internal* goals and capabilities to organizational behavior and effectiveness.

Research applying prospect theory, for example, has demonstrated that individuals use targets or "reference points" in evaluating risky choices and that their behavior depends upon whether they perceive themselves as above (better than) or below (worse than) a specific target they choose (Kahneman and Tversky, 1979). Moreover, Fiegenbaum and Thomas (1988) confirmed prospect theory as a descriptor of behavior at the firm level: They found that organizations behaved as risk-takers when below their reference point but avoided risk when above. An organization's (or decision maker's) selection of a "reference point" thus appears to have important implications for strategic choice behavior. By signaling organizational priorities and overall direction, top managers, either wittingly or unwittingly, focus the attention of organizational members on particular goals and objectives; in so doing, they define the "strategic reference point" for the firm.

According to prospect theory, choosing reference points which the firm is clearly "below" should result in behavior and performance measurably different from cases where reference points are selected which the firm clearly exceeds. For example, it is now generally accepted that in the years following World War II, the large American market enabled many U.S. companies to be world leaders. 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 without risking the overall profitability of the firm. However, over the past decade, many new Japanese-based 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). Incumbent firms were slow to recognize that the "rules of the game" had changed. Locked into a particular set of assumptions about their industry, the nature of competition, and strategic management, such firms were often unable to alter their behavior. Large-scale investments had to be made regardless of the implications for short-term profitability. Regaining competitiveness demanded frequent and extensive organizational change. Such transformation required a broader vision and greater risk-taking. In short, top managers were required to select and deploy a different set of "reference points" than had been used in the past.

This paper takes the position that understanding a firm's choice of reference points is an important aspect of strategic management. 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 predicts that strategic behavior and performance can be influenced directly by the choice of reference points. After a review of the relevant literatures, the paper develops the concept of the Strategic Reference Point (SRP) which is composed of three dimensions: 1) conditions internal to the firm; 2) conditions external to the firm; and 3) time (i.e. future and past orientation). Taken together, the three reference point dimensions operationalize the structure of the firm's "mission" and "vision". Firms are expected to vary widely with respect to which dimensions or elements of the SRP they emphasize. A theory is therefore developed which specifies the optimal SRP structure and propositions are proposed which articulate the expected relationships between the SRP, strategic choice behavior, and firm performance. The paper closes with some suggestions for future research using the SRP concept.

STRATEGIC CHOICE BEHAVIOR: THE REFERENCE POINT

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 (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, or for actions having the same expected utility, they will choose the one with the lower risk (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 this theory.

Insert Figure 1 about here

A second stream of research (curve 2), which began with the empirical findings of Bowman (1980, 1982), however, asserts that individuals, and hence organizations, may be risk-takers under certain conditions. Furthermore, well-managed firms can increase returns and reduce risk simultaneously, suggesting an apparent "paradox" in the risk-return relationship. This kind of behavior is represented by the negative slope of curve 2 in Figure 1. Studies, such as Treacy (1980), Fiegenbaum and Thomas (1986), and Cool and Dierickx (1987) have found evidence for this kind of behavior.

A third approach (curve 3) starts from a different perspective. Fiegenbaum and Thomas (1988), for example, adopted "prospect theory" (Tversky and Kahneman, 1981) to predict strategic choice behavior. 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. The following example is taken from Tversky and Kahneman (1986) and is used to illustrate the central concepts underpinning prospect theory:

<u>Problem 1</u>. (N=150) choose between:
- A. A sure gain of $240 [84%]
- B. 25% chance to gain $1,000 and
  75% chance to gain nothing [16%]

<u>Problem 2</u>. (N=150) choose between
- C. A sure loss of $750 [13%]
- D. 75% chance to loss $1,000 and
  25% chance to lose nothing [87%]

It can be seen readily that Problem 1 deals with "gains" while Problem 2 deals with "losses." While options A and B in Problem 1 and C and D in Problem 2 are equivalent in their expected monetary returns, individuals revealed very different preferences. In Problem 1, most respondents (84%) displayed risk-averse behavior since they preferred the option with the lowest risk. Alternatively, the majority choice in Problem 2 (87%) was risk-seeking, since the preferred option contained the highest risk. This is a common pattern: choices involving gains are usually risk averse while choices involving losses are often risk-seeking. Thus, prospect theory argues that individuals 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 et al. 1980; Fishburn and

Kochenberger, 1979). Furthermore, Fiegenbaum and Thomas (1988) tested and confirmed prospect theory in the context of strategic choice for an entire organization. Other studies, such as Singh (1986) and Chang and Thomas (1989) have found evidence for similar behavior. In addition, Fiegenbaum (1990) confirmed another prediction of prospect theory in his empirical study where he 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.

In short, both individual and organizational choices appear to depend to a very great extent upon whether decision makers see themselves as being above or below a "reference point" used to describe the situation. Missing from prospect theory, 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 (as we saw in the above example), there has been no explicit treatment of what constitutes an appropriate reference point at either the individual or organizational level. Fortunately, several existing theoretical perspectives from economics, psychology and organization theory help to shed light on this problem from the standpoint of the firm.

RELATED THEORETICAL PERSPECTIVES

A central theme in strategic management has been the challenge of matching the demands of the external environment with the internal capabilities and values of the organization (Andrews, 1971; Hofer and Schendel, 1978). Since the external environment is constantly changing, often in unpredictable ways, maintaining this match or "fit" is no easy task and usually involves the need to overcome particular deficiencies or build new capabilities over time (Galbraith and Kazanjian, 1986; Itami, 1987; Prahalad and Hamel, 1990). Thus, the creation of a high aspiration

level-- a gap between the current state and some desired state-- has long been a part of management theory (e.g. March and Simon, 1958). 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. 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 which are discussed briefly below.

Insert Table 1 About Here

Motivation Theory

Motivation theory focuses upon internal organizational factors which serve to encourage higher levels of individual effort and productivity such as work design, reward, recognition, achievement, growth, and responsibility (McClelland, 1961; Herzberg, 1968; Hackman and Oldham, 1980). Expectancy theory, for example, is premised upon the notion that motivation level depends upon effort generated in pursuit of valued rewards or outcomes (Nadler and Lawler, 1977). Extensive research also shows that goal-setting can be used to motivate people to perform more effectively (Latham and Yukl, 1975). In order to be effective, however, goals must be clear, specific, and challenging; such "stretch" goals serve to motivate people to achieve higher levels of performance (Locke et al, 1981). Motivation theory is thus based largely upon efforts to design jobs and identify individual targets and objectives (e.g. sales levels, production targets, skills) which raise the "aspiration level" of individual employees.

Resource-Based Perspective

This perspective argues that sustainable competitive advantage can only be achieved when firms possess internal resources that are rare, hard to copy, and not substitutable (e.g. Wernerfelt, 1984; Barney, 1989). Firm resources include all assets, attributes, processes, and knowledge controlled by a firm that enable it to conceive of and implement effective strategies. This suggests that management focus its attention upon identifying and building the unique "core competencies" needed for competitive success (Prahalad and Hamel, 1990). Thus, the resource-based perpective identifies gaps in internal capability and sets targets for the development of new, sustainable organizational competencies.

Industrial Economics

This theoretical perspective clearly focuses on forces external to the firm. It defines reference or comparison groups at several levels, including the strategic group to which the firm belongs (Porter, 1980; Cool and Schendel, 1987), the industry as a whole (Bain, 1956; Caves, 1977), and key competitors in other industries (Porter, 1986). Strategic choice, if the theory allows any, is premised upon comparison of one's current positioning against either the industry as a whole or a specific set of competitors which serve as a reference group. Thus, Industrial Economics serves to define a "gap" between the firm's current competitive position and some other more desireable position relative to competitors.

Resource Dependence

Resource dependence suggests that organizational survival is premised upon the ability to acquire and maintain access to resources (Pfeffer and Salancick, 1978). This perspective therefore emphasizes the means by which organizations manipulate important external groups through strategies such as vertical integration, joint

ventures, coalitions, and cooptation (Thompson, 1967; Pfeffer, 1972; Pfeffer and Nowak, 1976). Key external groups include competititors, suppliers, and customers. Constraints imposed by these key constituencies form the basis for efforts to modify or improve the firm's position relative to those organizations upon which it depends. Resource dependence therefore defines a "gap" relative to interdependencies with key task-oriented external parties.

Institutional Theory

Like the resource dependence perspective, institutional theory presumes that strategic choice is embedded in a system of external interdependencies (Selznick, 1957; Meyer, Scott and Deal, 1983). However, rather than asserting the primacy of competitors, customers or suppliers as the "comparison" groups, it starts with the premise that organizations are social as well as technical phenomema. Firms therefore adopt patterns that are defined externally as appropriate to their environments and that are reinforced in their interactions with other organizations (Meyer and Rowan, 1977). In short, there are strong pressures for firms to become "isomorphic" with their environments, adopting the practices and processes that are defined as "successful" or "appropriate" (DiMaggio and Powell, 1983). Technical or economic efficiency, a dominant concern of the Industrial Economices perspective and, to some extent, the Resource Dependence perspective, is of less concern than maintaining a facade that meets the subjective demands of the firm's various constituencies. In this sense institutional theory is similar to the "stakeholder" approach to strategic management (Freeman, 1984).

Corporate Identity

Writers addressing the topic of corporate identity emphasize that it gives meaning to the organization's activities and provides a sense of belonging for employees (Westley and Mintzberg, 1989); the firm's identity is linked to its basic philosophy and values (Tregoe et al, 1989; Dutton and Dukerich, 1991). It facilitates a shared perspective on the part of all employees-- an emotionally appealing corporate "dream" (Torbert, 1987). The firm's identity is often deeply embedded in tradition and past success. The past therefore provides an important frame or point of departure for today's decisions. In this sense, the corporate identity can both motivate organizational members by providing a backdrop for continued achievement, or serve as an impediment to change as the identity serves to block recognition of new threats or opportunities. In either case, it allows organizational members to place their actions in context and provides a clear basis for day-to-day decision-making.

Strategic Intent

Strategic intent provides a sense of corporate purpose, often expressed as a long-term "mission" (Hamel and Prahalad, 1989). The focus of the firm's mission might center on products, markets, competitors, technology, or ideals (Westley and Mintzberg, 1989). In effect, top managers define long-term goals and then set targets either internal to the organization (e.g. developing capability) or external (e.g. overtake a competitor) which serve to inspire organizational members to higher levels of achievement (Hasegawa, 1986; Imai, 1986). Thus, strategic intent projects the organization deep into the future and provides organizational members with a frame of reference for making choices today which are consistent with that sense of purpose and direction.

Summary: Common Themes

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 are judged. However, each perspective deals with different content and posits a different mechanism of comparison. As Table 1 indicates, the theories can be categorized broadly into three groups-- those focused upon factors *internal* to the firm (Motivation Theory, Resource-Based Perspective), those involving factors *external* to the firm (Industrial Economics, Resource Dependence, Institutional Theory), and *time*-based concerns (Corporate Identity, Strategic Intent).

Industrial 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. Similarly, the Resource-Based Perspective establishes "organizational capability" as the primary reference point, 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 cover a broad range of potential reference points. Each perspective constitutes a "piece of the puzzle" in that it defines a particular decision frame thereby creating a "gap" or aspiration level. To develop a theory of *strategic* reference points, therefore, it appears necessary to consider the external, internal, and time dimensions, treating them simultaneously as an integrated package.

THE STRATEGIC REFERENCE POINT MATRIX

The first requirement for conceptualizing the "strategic reference point" is the articulation of an appropriate set of factors and dimensions to consider. As was argued by Tversky and Khaneman (1986) and others, however, there is no formal theory available for formulating reference points. It should be noted that the concept of "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), however, used the industry's median return on equity (ROE). The reason for this reference point selection reflects the financial literature's suggestion that firms adjust their performance to the industry average (Lev, 1969; Frecka & Lee, 1983).

These studies indicate that any factor(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 factors to consider, we propose a three-dimensional reference point "matrix" which includes the wide range of factors identified in the literature review. Specifically, a Strategic Reference Point Matrix is developed consisting of three major dimensions: (1) factors internal to the firm, (2) factors external to the firm, and (3) time (Figure 2).

Insert Figure 2 about here

The Internal Reference dimension

As Motivation theory and the Resource-Based perspective suggest, factors internal to the firm are crucial to success and constitute important reference points for organizational members. 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 profitability or sales and to hold 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 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 et al, 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, quality control) rather than technology (Womack, Jones, and Roos, 1990). Companies like Domino's Pizza, however, have clearly set distribution as the 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 company-wide capabilities which serve as a backdrop to functional operations; these "cross-cutting" capabilities include an emphasis upon cost position (Porter, 1980), quality (Imai, 1987), 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 versus innovation), the themes are not necessarily 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 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 points (Table 2). An analysis of a firm's strategy and organization (particularly it's planning, resource allocation, and reward systems) 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 would establish a set of reference points quite different from a firm which emphasizes technological development and product innovation as its focal point.

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 in its external 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 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 points: 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 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 it's 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 constitutes an important 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 quality (e.g. Perrow, 1984; Davis, 1990).

Many companies are concerned with sustaining 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 and 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 $14B. 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 sustainability (Davis, 1990; Piasecki and Asmus, 1990; Woodruff and Peterson, 1991). Dupont, for example, aims to anticipate, seek, and respond to public values concerning the environmental impacts of their operations and has incorporated environmental concerns into the corporate mission. Their recent decision to phase out the production and sale of CFC's due to their 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 source of reference points for the firm. The time dimension can be divided readily 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-- ten or twenty 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 resources and capabilities. But they created an obsession with winning at all levels of the organization, and then sustained the obsession over the 10 to 20 year quest for global leadership. At Matsushita, for example, founder Konosuke Matsushita developed a grand 250-year mission which is expressed through the "Seven Spirits of Matsushita." Each year, Matsushita rededicates the company to it's long-term mission by embedding it's short term goals within the strategic intent, captured through a slogan which serves as the theme for the year.

The Reference Surface

The internal and external dimensions interact with the issue of time to create what might be called a reference surface-- comparisons of the firm to itself and external benchmarks at different points in time. For instance, a firm might compare its historical level of investment in research and development (e.g. a tradition of

strong R&D competence) to current levels and use this as a basis for justifying increases in spending for this activity. The case becomes even stronger if competitors also seem to be investing more, or customers seem to be demanding product innovation. A firm may also use its strategic intent as a touchstone for reallocating resources to different activities. Embedding today's strategic choices in a long-term quest may facilitate changes that might otherwise be difficult to make. Thus, for any firm, the dimensions and elements of the SRP matrix interact to form mulitple targets and points of comparisons.

THEORY DEVELOPMENT

The strategic reference point 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*.

Strategic Choice Behavior

The position of the firm relative to its strategic reference point 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.

Insert Table 3 About Here

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 repetoires, 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 repetoires, 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.*

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 could 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 strategic reference point.

The three dimensions of the Strategic Reference Point 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 begun to argue that effective strategic management requires a balancing and simultaneous mastery of seemingly contradictory or "paradoxical" 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, 1991). Applying the logic of the "paradox" perspective to the SRP suggests that the most effective firms should evidence reference points which emphasize simultaneously all three dimensions of the matrix. Through such a *multidimensional* reference point, managers might help direct the attention of organizational members to multiple concerns. Such

organizations should possess a superior understanding of the situation thereby facilitating performance on several dimensions. This suggests the following four propositions:

Proposition #2a: Firms possessing both an Internal and External reference point will outperform firms which emphasize one dimension over the other.

Proposition #2b: Firms possessing both a Past and Future orientation will outperform firms which emphasize one element over the other.

Proposition #2c: Firms possessing multidimensional SRPs-- a simultaneous emphasis upon Internal, External, and Time dimensions-- will outperform firms with less complex reference points.

Proposition #2d: Firms possessing multidimensional SRPs will perform on more dimensions (e.g. profitability, growth, quality, innovation, social responsibility) than will firms with less complex reference points.

Configuration. Beyond the specific content of the SRP, it is also important to examine the configuration of the firm's reference point-- the relationships among the different dimensions and elements. 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 elements of the firm (strategy, structure, technology, systems, processes) and it's environment. Applying this logic to the SRP concept, it might be expected that where multiple reference points are evident, the most effective firms will demonstrate *internal consistency* among the elements of the SRP. For example, where a firm identifies an industry leader as its primary external reference point, then it's targets for strategic inputs and outputs should be visibly 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, 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: They 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 that 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; Romanelli 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 consisent 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* performance. A static SRP might eventually lead to stagnation. This suggests the following proposition:

Proposition #4: The most effective firms will periodically revise or alter their SRP to focus attention on new challenges and avoid complacency and stagnation.

Consensus. The last characteristic to consider relates to perceptions about the SRP within the organization. The literature on top managment 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). But 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 the firm's SRP.*

FUTURE RESEARCH

To apply the concept of the Strategic Reference Point, both in theory and practice, it must first be operationalized: variables must be defined and a system of measurement and scoring devised. Operationalization should be pursued both objectively and subjectively. *Objective* indicators for each of the elements of the SRP Matrix could be defined through 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" factors such as technology, production, and distribution. To create a reference point, these data could be benchmarked against the industry leader, a particular strategic group, or the overall industry average. Its placement "above" or "below" each element of the SRP matrix, coupled with a scoring system that could be devised, would lead to classification of the firm in the matrix and would allow systematic investigation into the linkages between SRP, strategic choice behavior, and firm performance.

While objective measures of the SRP should prove to be very 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 elements 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 versus 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 "Strategic Reference Point 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 could have important implications for both research and practice.

Once operationalized, Strategic Reference Point Theory could be used to analyze several specific issues of current strategic relevance. For example, it could be usefully applied to the study of *innovation and entrepreneurship*. An accepted belief is that entrepreneurship deals with risk-taking behavior (e.g. Smith and Miner, 1983; Van de Ven, Hudson, and Schroeder, 1984). If high risk-taking behavior is a necessary condition for success, the SRP concept suggests that entrepreneurs and innovators probably see themselves as below a reference point(s). What are the reference points used by successful entrepreneurs? Do innovative firms emphasize a different set of strategic reference points than firms which defend established strategic positions? Empirical research applying the concepts developed in this paper could help answer these questions.

A related research question is how *small firms* compete successfully against large ones. Previous research has indicated that an important element for small firm success is a "focus" strategy, which means, high risk-taking behavior (e.g. Porter, 1980). The SRP concept could aid in answering such questions as: What are the reference points that successful small firms use? What is the relative importance of the distance from different reference points. In addition, *interfirm collaboration* has become an increasingly important phenomenon over the past decade. While previous research has explored how to manage joint ventures and strategic alliances (e.g. Kogut, 1988; Hamel, Doz, and Prahalad, 1989), there are still many questions

which remain. For example, which firms are the best candidates for strategic alliances? What reference points do they use? How much risk are they willing to take and why? Do they differ systematically with regard to reference points?

Another important strategic issue has to do with the appropriate level and type of *diversification*. Previous research has focused upon the concepts of relatedness, risk, and firm performance (e.g. Rumelt, 1982; Montgomery and Singh, 1984). The SRP concept offers a new point of view on this issue. For example, what is the reference point for firms that change their diversification strategy? Are there distinctive reference points for firms which diversify through acquisition versus internal development? What is the reference point that firms use when deciding to enter new markets? Can we predict which firms will enter new markets (e.g. Eastern Europe, Middle East)?

Finally, the issue of *environmental sustainability* is emerging as a key concern for the 1990s (e.g. Davis, 1991). Beyond the immediate demand for "green" products, governments around the world are requiring that firms adopt a more systematic approach to product and process technology to save energy and materials, prevent pollution, and minimize waste. The response to these demands by corporations has been highly variable with some taking a strongly proactive orientation while others delay or resist the call for "greening". This raises several interesting questions: How can multinational corporations manage cross-border and international environmental problems most effectively? Is innovation within existing large corporations or the creation of new "green" start-ups the most effective way to respond to environmental demands? In terms of the SRP concept, what differentiates those firms which move rapidly toward environmental sustainability from those which resist? Are there fundamental differences in the reference points adopted by "green" firms?

CONCLUSION

By signaling what issues are important, top managers establish the "strategic reference point" 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 determined by the reference points which are consciously or unconsciously adopted. The Strategic Reference Point Theory developed in this paper provides both a research and diagnostic tool for assessing the structure and configuration of the firm's mission and vision. By explicitly "managing" the reference point(s) used by their firms, top managers would appear to 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 Strategic Reference Point Matrix. The matrix contains three dimensions-- internal capability, external conditions, and time--that 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-averters in the domains of losses and gains respectively. Second, we predict that firm performance will be directly influenced by the content and configuraion 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.

Strategic Reference Point Theory appears to have important implications for research in management and strategy. For example, researchers from

organizational theory, population ecology and strategic management 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, strategic reference points represent another set of contingencies that impact performance. The SRP concept offers the potential to enrich the strategic management paradigm 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 (e.g., organizational behavior, organizational theory, population ecology, strategic management, finance, and economics) to explore further the implications of the Strategic Reference Point.

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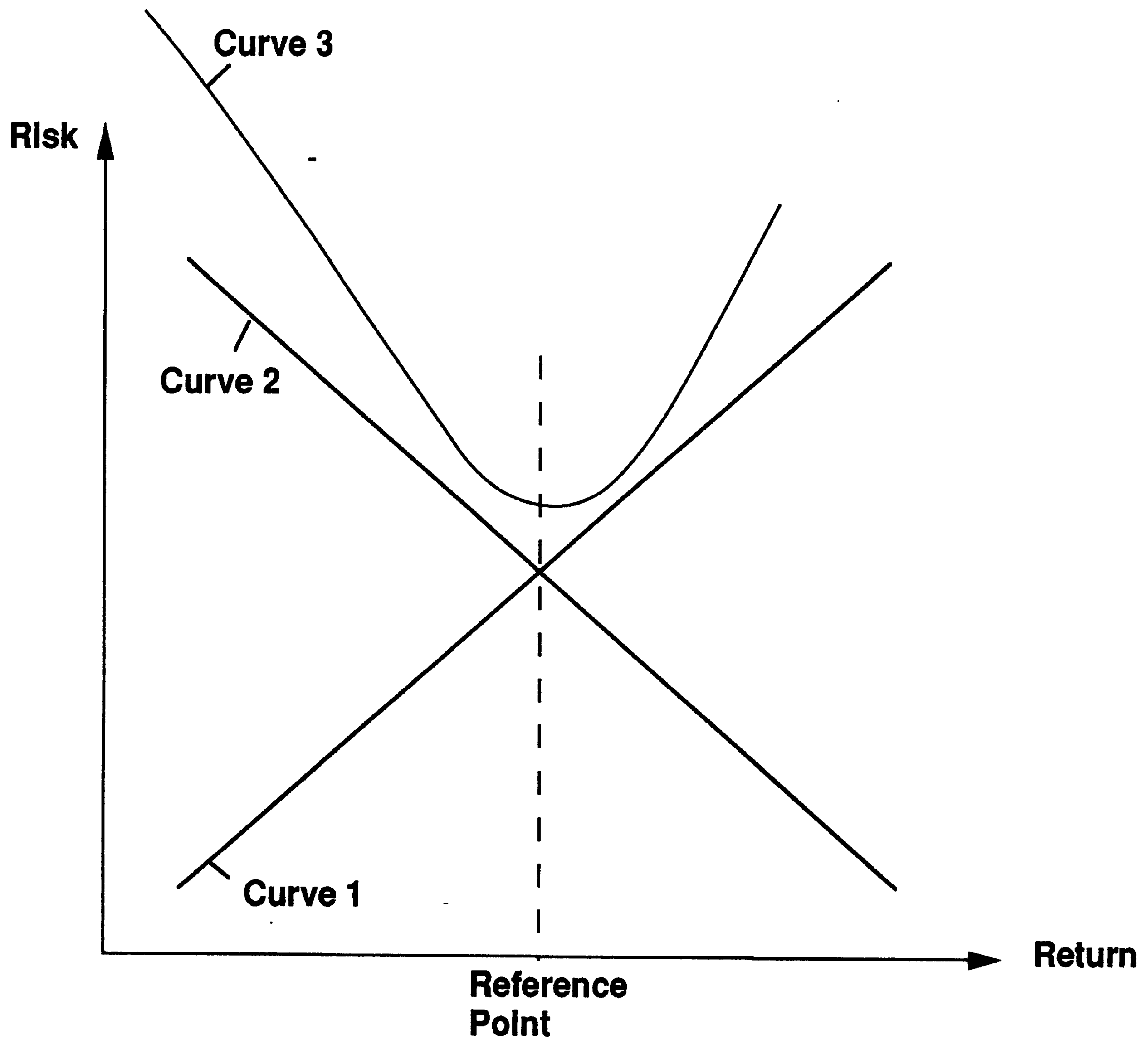
FIGURE 1

Three Models of Strategic Choice Behavior



Notes:

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

FIGURE 2

The Strategic Reference Point Matrix

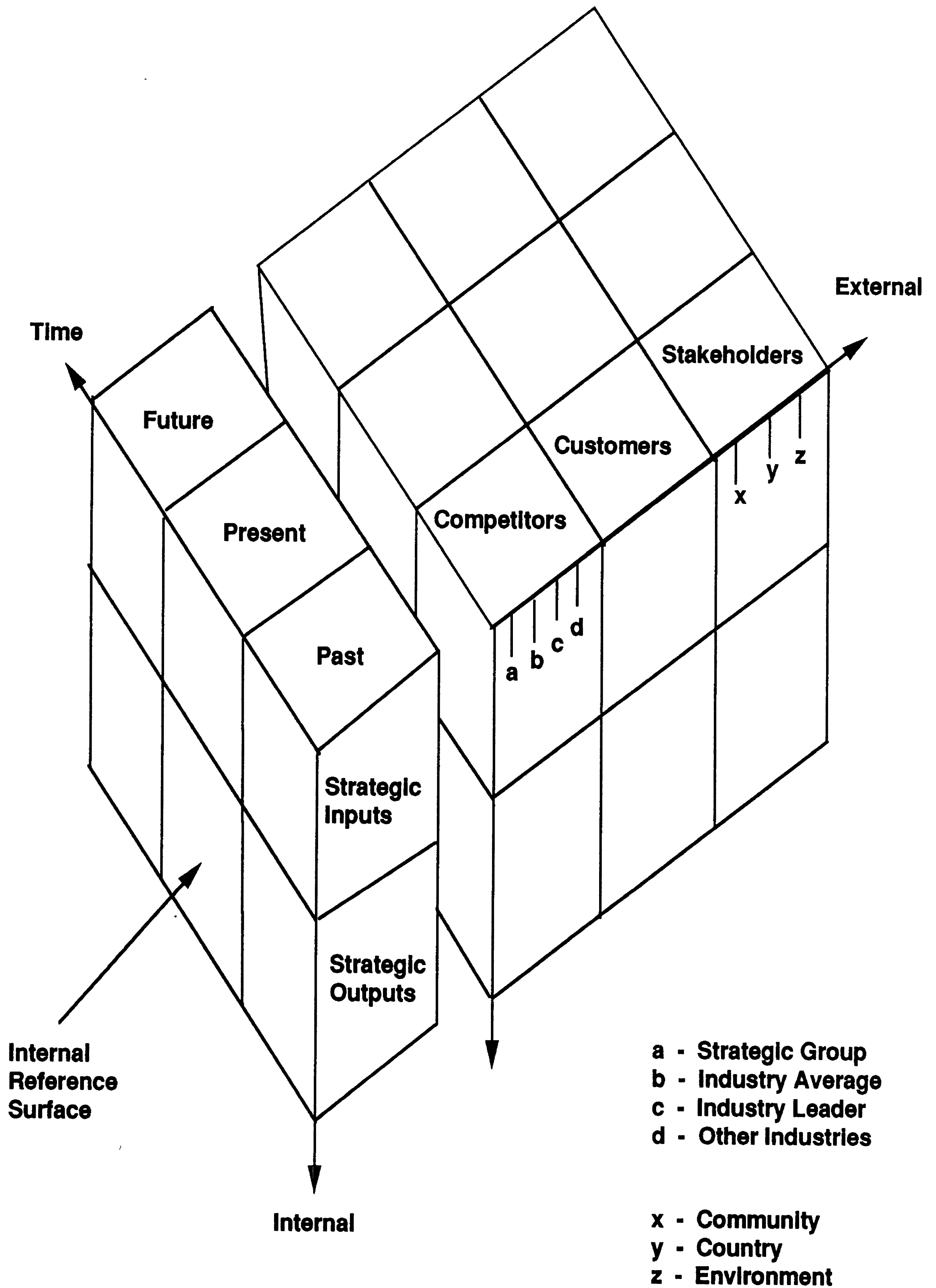


TABLE 1
Related Theoretical Perspectives: A Summary

Theoretical Perspective	Reference Point Emphasized	Fundamental Prescription	Citations
Motivation Theory	Internal organization • individuals • groups	Design work and set goals for higher performance	Lathan & Yukl (1975) Nadler & Lawler (1977) Hackman & Oldham (1980)
Resource-Based View	Internal organization • firm-wide resources	Build unique competencies	Wernerfelt (1984) Barney (1989) Prahalad & Hamel (1990)
Industrial Economics	External conditions • industry • key competitors	Beat the competition	Bain (1956) Caves (1970) Porter (1980)
Resource Dependence	External conditions • competitors • suppliers • customers	Mimimize constraints on resources	Pfeffer (1972) Pfeffer & Nowak (1976) Pfeffer & Salancik (1978)
Institutional Theory	External conditions • stakeholders • interdependencies	Meet demands of society	Meyer & Rowan (1977) DiMaggio & Powell (1983) Meyer, Scott & Deal (1983)
Corporate Identity	Time • past traditions • philosophy	The past shapes what is possible	Westley & Mintzberg(1989) Torbert (1987) Dutton & Dukerich (1991)
Strategic Intent	Time • long-term purpose • mission	Strategic intent informs current decisions	Hasegawa (1986) Imai (1986) Hamel & Prahalad (1989)

TABLE 2

Strategic Inputs

Value-Added Activities	Cross-Cutting Capabilities			
	Cost	Quality	Speed	Innovation
Technology				
Product Development				
Production				
Distribution				

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, et al. 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