Exploring the Effect of Customer Satisfaction on Organisational Performance – Explanations for a Diminishing Relation.

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ABSTRACT

Prior research has found that the relation between customer satisfaction and performance is equivocal. This study explores explanations for this finding, paying attention to whether increases in customer satisfaction can provide diminishing improvements to organisational performance. The concept of a point at which returns to customer satisfaction begin to diminish is particularly important to estimating the optimal amount that should be spent on trying to increase customer satisfaction. This phenomenon will be investigated by examining the outcomes of a specific service quality initiative at the Melbourne property of a leading luxury hotel chain operating throughout Australia and New Zealand.
INTRODUCTION

A large number of studies have found that a positive relation exists between satisfied customers and organizational performance. There are also many, however, which have disputed that satisfied customers are necessarily loyal and deliver large profits. What could be causing this result? Surely spending to improve customer satisfaction will deliver big benefits to retention and the bottom line. Could it be that organizations may be over investing in improving customer satisfaction given that the benefits are far exceeded by the costs? Are the outlays associated with improving service quality unjustified given that customers who have reached a certain level of satisfaction are not necessarily going to significantly alter their spending habits?

This study will explore these issues by looking at the outcomes of a particular service quality initiative. More specifically, it will examine whether the benefits obtained to retention and financial outcomes outweighed the costs of the initiative by looking at the impact of diminishing returns to customer satisfaction. The expectation based on prior literature is that retention, revenue and revenue growth will improve for customers at the low end of the satisfaction continuum before the initiative. It is also expected that customers at the higher end of the satisfaction continuum before the initiative will not alter their loyalty or spending much at all. Thus, if customers are highly satisfied already there may be no point to spending to improve service quality as it may actually be harmful given that costs have risen. This study will attempt to examine the determinants and impact of this relation between customer satisfaction and performance.

The findings and conclusions of research conducted by Ittner and Larcker (1998a) in the US telecommunications sector will be further explored here. They emphasised that a very interesting extension of their research would be a sophisticated analysis of the negative relation between customer satisfaction and performance that they found in selected industries to specifically explore whether the results are due to model misspecification or firms in a given industry “over investing” in customer satisfaction. The contribution of this study is the consideration of service quality spending and the point at which further spending becomes suboptimal given that returns to improving customer satisfaction diminish.

This study is set in the context of an increasing emphasis placed on a combination of financial and non-financial performance measurement (Ittner and Larcker 1998a, 1998b, Stivers et al 1998). The shortcomings of traditional financial performance measurement systems are now well cited. Principally they revolve around financial measures encouraging short term thinking, focusing on past performance during set time intervals and being based upon historical data (Nowak and Anderson, 1999, Eccles 1991). Financial performance measurement alone is unsuited to the rigours faced by organisations operating in today’s modern competitive environment.

Criticisms such as these have led to a renewed interest in developing a more long-term strategy through the implementation of new performance measurement frameworks, such as the balanced scorecard. Kaplan and Norton (1992, 1993) assert that a collection of both financial and non-financial measures is required to properly align the efforts of an organisation with its strategic vision. Ittner and Larcker (1998b) drew attention to the significant contributions that could be made by investigating contingency variables that affect the predictive ability, adoption and performance consequences of such non-financial measures. They theorise that different industries, strategies and environmental factors may all potentially impact the relation between non-financial measures and subsequent accounting performance. Said, HassabElNabie and Wier (2003) also state that little empirical evidence exists on whether non-financial performance

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1 Retention and customer loyalty are used interchangeably throughout this study
measurement yield significant economic benefits. This study will improve our understanding of and assess the importance of the non-financial measures “service quality”, “customer satisfaction” and “customer retention” in a setting that faces intense competitive pressures and the highest customer expectations. Zeithaml (2000) further confirms the importance of understanding how service quality impacts customer satisfaction and subsequent financial outcomes. This study will pay particular attention to whether an organization can over invest in service quality improvements to the detriment of profitability.

The study will be conducted in the tourism sector. Given recent turbulence from events such as September 11, the Bali bombing, the Ansett collapse, the Iraqi war, SARS virus and the rising Australian dollar, significant additional Federal funding has been recently provided in an attempt to boost the competitiveness of this sector. Organisations are vigorously searching for means to grow customer levels and improve profitability. Thus, this study will provide valuable and timely insight into how enhancing customer satisfaction can lead to improved outcomes for this and similar industries.

In summary, the research question to be investigated by this study is what are the determinants of the relation between customer satisfaction, customer retention and performance?

**LITERATURE REVIEW**

Figure 1 summarises the relations between customer satisfaction, customer retention and financial outcomes that this study will attempt to test.

[Insert Figure 1 here]

**Customer Satisfaction and Organisational Performance**

Customer satisfaction has been found to be an important non-financial indicator of financial outcomes. Customer satisfaction refers to the customers overall appraisal of the purchase encounter. Nowak and Anderson (1999) assert that components of overall customer satisfaction include convenience, price, availability, personal interactions and overall value.

A large number of studies have found that customer satisfaction has a positive impact on financial outcomes. Anderson, Fornell and Lehman (1994) found that on average customer satisfaction is positively associated with return on investment in 77 Swedish firms. This advantage is believed to persist over time, and so the net benefits from customer satisfaction may not be fully reflected in current periods accounting performance. Banker, Potter and Srinivasan (2000) found that customer satisfaction measures were positively associated with future accounting performance in 18 hotels. Said, HassabElnaby and Weir (2003) found that non-financial measures are significantly associated with future accounting-based and market-based returns. Behn and Riley (1997) found that customer satisfaction is associated with operating income and revenues in US Airline Industry.

Further support for the positive relation between customer satisfaction and organizational performance was established by Ittner and Larcker (1998a) who found modest support that customer satisfaction is a leading indicator of business unit accounting performance and growth in customers. They also found that the disclosure of customer satisfaction measures provides information to the stock market on expected future cash flows. Sears, Roebuck and Company claimed that a four percent increase in customer satisfaction led to an estimated $200 million increase in revenues and, ultimately, to an estimated $250 million increase in market capitalization (Rucci, Kirn and Quinn, 1998).
**The Link between Customer Satisfaction, Customer Retention and Organisational Performance**

It has been found that customer satisfaction impacts financial outcomes via improved customer retention\(^2\). Lee, Lee and Feick (2001) review customer loyalty as having been operationalised in prior research as a behavior (hard-core loyalty, repeat purchase probability etc) or an attitude (brand preference, commitment, intention-to-buy etc).

It has long been understood that satisfaction is a key determinant of customer loyalty to a product or service offering. Heskett, Jones, Loveman, Sasser and Schlesinger (1994), in a comprehensive analysis of 480,000 Xerox customers, revealed that customers giving a five (highly satisfied) were six times more likely to repurchase Xerox equipment than those giving a four (satisfied). Coyne (1989) argued that investments to retain loyalty work best near either the excited or the dissatisfied end of the service spectrum, not in the middle. At the high end, investments to increase the number of customers excited about service can significantly payoff through a higher frequency of repeat purchases. In addition, Cronin and Taylor (1992) found that satisfaction has a significant effect on purchase intention.

Improved customer retention has significant financial payoffs for an organisation. The service-profit-chain framework of Heskett, Jones, Loveman, Sasser and Schlesinger (1994) purported that profit and growth are stimulated primarily by customer loyalty. In addition to Xerox they highlighted the example of Banc One, which attributed an ROA more than double its competitors to a new focus on measurement of customer retention, the number of services used and the level of customer satisfaction as opposed to financial measures alone.

Reichheld and Sasser (1990) argued there should be a strong focus on customer satisfaction given that profits can be increased by preventing customers from defecting. Customer defections had a greater impact on profit than economies of scale, market share and unit costs. Results showed that customer retention leads to improved financial outcomes through lower costs, increased purchases, higher tolerance for a price premium and enhanced word-of-mouth communication. They estimated that a five percent increase in customer loyalty can produce profit increases ranging from 25 percent to 85 percent. They also discuss that MBNA America found a five percent improvement in defection rates increased its average customer value by more than 125 percent. They concluded that customer loyalty deserves as much consideration as market share.

Bowen and Chen (2001) found a positive correlation between loyal customers and profitability due to higher repeat business and reduced propensity to shop around. Anderson and Sullivan (1993) showed a consistently high satisfaction level may generate a long-run reputation effect, thereby insulating firms by reducing the price sensitivity of customers. Lee, Lee and Feick (2001) estimated that an increase in customer retention rates of only five percent leads to the average net present value of a customer rising by 35 percent for software companies and 95 percent for advertising. In addition, they found consistently highly satisfied customers are less likely to defect when prices rise.

\(^2\) Other mediating variables as highlighted by Ittner and Larcker (1998a) include reduced price elasticities, lower marketing costs through positive word-of-mouth advertising, reduced transaction costs and enhanced firm reputation.
Conflicting Results – Diminishing Returns?

Though the studies discussed above suggest that superior financial performance will be achieved by investing heavily in service quality to improve customer satisfaction there is evidence that this may not necessarily be the case. Anderson, Fornell and Rust (1997), found weak or negative association of customer satisfaction with ROI in service firms. Similarly, a survey by Ittner and Larcker (1998b) of vice presidents of quality for major US firms found that only 28 percent could relate their customer satisfaction measures to accounting returns and only 27 percent to stock returns. Ittner and Larcker (1998a) also found that firm level results for the impact of customer satisfaction on performance varied by industry, with positive relations in some industries and negative or insignificant relations in others.

Further recent studies have observed that the relation between customer satisfaction and performance is not necessarily constant. The most well recognised study in this area was conducted by Ittner and Larcker (1998a) in a telecommunications firm. Their study looked at the effect of customer satisfaction on retention, revenue and revenue growth for a sample of 2491 business customers. Their results highlighted that the relation between customer behaviour and financial results was not constant but varied at different satisfaction levels.

Further, Yeung, Ging and Ennew (2002), used data from the American Customer Satisfaction Index (ACSI) and firm level performance to examine specifically the extent to which relations between satisfaction and performance may be non-linear. The first model they tested implied that there are diminishing returns to satisfaction and that additional satisfaction will have little impact on profitability beyond a certain point.

This study has the potential to make an important contribution to the existing body of literature given that the concept of diminishing returns to customer satisfaction is yet to be explored in depth. Further explanations for the determinants of the relation between customer satisfaction, retention and performance will be explored during my presentation at the University of New South Wales.

RESEARCH METHOD

This research will be conducted through a field study of a single site. A combination of quantitative and qualitative data collection methods will be used to obtain the required information. Quantitative data for service quality costs, customer satisfaction, retention and financial outcomes will be obtained through extraction from the relevant archival records. Qualitative data primarily regarding the service quality initiative and management’s perception of its success will be obtained from a series of semi-structured interviews.

Data will be collected covering a 15 month period from March 2004 to June 2005. Data will be required to be collected at different points in time. Overall customer satisfaction levels will need to be examined before and after the initiative to gauge the impact that it had on satisfaction. Lagged retention, revenue and revenue growth levels for customers in the sample will then need to be examined for the proceeding 12 months to gauge the impact of customer satisfaction on organizational performance.

The research site, customer service initiative and data collection are further discussed below.

Research Site

The research site is a leading luxury hotel chain operating throughout Australia and New Zealand that is owned by a Singaporean multinational company. It is the largest and fastest
growing owner of five star hotels throughout the region, with exclusive properties in central Sydney and Double Bay, Brisbane, Adelaide, Melbourne and Auckland. The focus of this study is the Melbourne property (hereafter referred to as HOTEL).

The HOTEL is a 283 room, five star luxury hotel located in the heart of Melbourne’s CBD. The apartment style suites contain kitchen, lounge/dining and ensuite with spa bath. The property also has a restaurant, bar and café, indoor/outdoor rooftop pool, sauna, mini-gym, 12 function rooms and six private business offices. These facilities highlight the differing clientele targeted by the HOTEL: leisure, corporate and conference/banquet guests. International guests and organised travel groups also constitute a high percentage of regular patrons.

Customer Service Initiative

Positioned in the five-star luxury market, there is a continual need to exceed customer expectations and differentiate the HOTEL from similar competitors, of which there are at least six in the five-star bracket in Melbourne. The Group Executive Chairman recently highlighted in a press release that “it is time the hotel industry thought about the true meaning of hospitality and found ways to innovate and improve, much as the airline industry has done over the past decade as they roll out personal entertainment systems, beds in business class and constantly improving menus and travel aids”. He further committed to service innovations that will directly benefit guests.

Innovative initiatives throughout 2003 included free movies, a romance and seduction package and competitive rates in key holiday periods. Prior to this, the HOTEL underwent a significant soft refurbishment of each room to modernize the look, a safe was installed in every room, room entry was changed to electronic swipcard and the gym facilities were upgraded.

Of particular interest to management at present is the impact of an initiative for all guests that was announced in March 2004. HOTEL cut costs on all minibar items by 50 percent and reduced interstate and overseas calls from hotel landline phones significantly. Ten minute calls to the US and the UK for example now cost less than five dollars, which is 90 percent less than in some hotels. It is hoped that these measures will help guests relax more in their rooms without stressing about exploitative mark-ups on mini-bar items and phone calls. HOTEL has also promoted that this initiative may save corporate clients tens of thousands of dollars in ancillary travel costs. The policy of many of these clients at present is that mobile phones must be used in preference to hotel landlines.

This initiative is on trial from March 2004 until the end of May 2004. Management planned to solicit feedback from guests and the corporate sector throughout this time to gauge its value and how it could be enhanced.

Data Collection

Customer Service Initiative

More detailed information about the customer service initiative being trialed will be obtained through semi-structured interviews and investigation of internal company documents. The Sales and Marketing director and other marketing staff will be central to data collection at this phase. It will be particularly important to gather comprehensive information about the following:

- What led to the decision to reduce mini-bar and phone call charges?
- Did customer feedback emphasise dissatisfaction with these charges?
- What are the new mini-bar and phone call charges? What is the reduction in charges?
- Are there any formal forecasts or conjectures about the financial impact of this initiative?
- Over what time frame is this initiative expected to have an impact? Will there be a lag? What is the expected duration of the financial impact?
- How is the initiative being communicated to guests?

From management responses to the above questions, it is anticipated that a qualitative assessment can be made as to whether service quality has been enhanced through this initiative. If customers have complained that costs are too high and the hotel can confirm that they are shouldering some of the costs that would otherwise be on-charged then customer service quality from the customer viewpoint will likely be enhanced. It is also important that there is significant promotion of this initiative to guests for there to be any impact on customer satisfaction.

The gathering of quantitative data about the cost of the service initiative to the hotel is also required at this stage. The study requires actual costs of the initiative for each of the hotel guests that will be included in the sample. These will primarily be the phone charges and food and drink costs now being borne by the hotel, but may also include promotion or other miscellaneous costs related to the initiative (estimates per guest will be sufficient here). These costs will be required for the hotel guests for one stay during the trial period.

**Customer Satisfaction**

This study requires customers to indicate the impact of this new initiative on their overall satisfaction level. This will be determined by comparing customer satisfaction levels before to those after the initiative, even if the guest is simply asked to what extent their overall satisfaction level changed after the initiative was implemented. It is anticipated that the hotel will have collected this information via customer survey, either at the time of stay or shortly after by phone call or some other means. HOTEL guests have likely been asked to quantitatively rank their satisfaction level. If they have answered open ended questions about their experience it may be necessary to code the responses as being very unsatisfied, unsatisfied, indifferent, satisfied or very satisfied.

The customer satisfaction data will be collected for the study from March to May 2004, the duration of the initiative trial. It is anticipated that hotel management will have sought detailed feedback from guests to analyse the success and viability of the initiative. Depending on how much feedback has been received, a random sample may need to be taken from the feedback received. Data of satisfaction levels for these particular guests before the initiative will then need to be collected.

Collecting satisfaction levels from customer surveys also represents an opportunity to close a gap in prior research, as highlighted by Zeithaml (2000). She criticised the collection of both dependent and independent variables from the organization in much of the service quality relation with profitability literature. She surmises that customer satisfaction from the customer viewpoint, rather than management perception of customer satisfaction, will better gauge the impact of service quality.

**Customer Retention**

Customer retention data will then be sought for those that satisfaction data was received from. Specifically, the change in number of stays for the twelve months after the stay during the trial compared to the twelve months before the trial is required. This time period should be long enough to allow the majority of satisfied customers to stay again if they planned to after their stay in the March to May 2004 period. Given it is a luxury hotel and guests are paying upwards of $250 per night, it is assumed that many are frequent travelers, whether for business or leisure.

This information will be retrieved from data stored within hotel information systems. Repeat stays at other properties will also be included as from a group viewpoint, the primary interest of management, this is a very beneficial outcome. Retention information is kept on an
ongoing basis by the HOTEL to monitor and analyse guest stays and give more welcoming and personalised service to regular guests.

**Financial Outcomes**

Revenue levels will also be required for those guests that satisfaction data was received from. Specifically the change in revenue level for the twelve months after the stay during the trial period compared to the previous twelve months will be required. Absolute revenue levels for each guest will allow a test of whether more satisfied customers are likely to spend more at the hotel than less satisfied customers. This information should be able to be collected from a customer database. If revenue data can only be retrieved in aggregate, it may be necessary to estimate revenue levels by considering number of stays and average room rates.

Revenue growth will be examined for the twelve month period after the stay during the trial compared to the twelve month period before. This data will support a test of whether customers at higher satisfaction levels increase their purchases more than those at lower levels.

Revenue growth will be calculated as follows:

\[ \frac{(REV \ Year \ Post)-(REV \ Year \ Pre)}{(REV \ Year \ Pre)}*100 \]

**Control Variables**

There are many factors other than customer satisfaction that may impact guest intention to stay again within the hotel group. This study will attempt to control for two of these variables.

Customer loyalty program membership is likely to encourage guests to stay again, particularly as guests pay $240 per year to become a member. This membership entitles the guest to one nights stay at any property, five 50 percent off vouchers at any property, dining discounts, special room rates, discounted car rental, an upgrade voucher and late checkout. Data will be retrieved from hotel information systems about whether the guests from whom satisfaction data was solicited are loyalty program members.

It is also likely that some corporate guests are locked in to similar loyalty programs and or agreements with the hotel in order to achieve discounts and benefits. In a similar manner to the program membership above, data will be retrieved about whether those who gave satisfaction data are locked into staying again by a corporate arrangement.
FIGURE 1

Relation between Customer Satisfaction, Customer Retention and Financial Outcomes.

CUSTOMER SATISFACTION → CUSTOMER RETENTION → FINANCIAL OUTCOMES


