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Are Customer Satisfaction Programs *Profitable?*

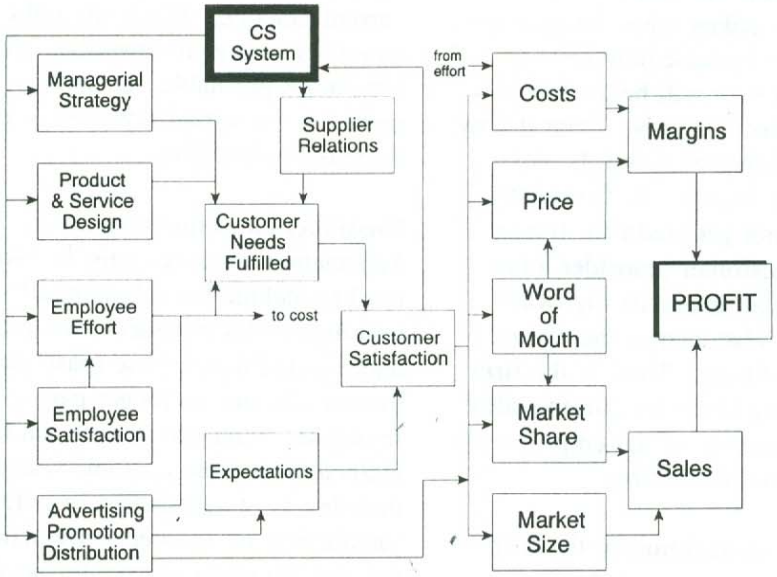
By Dr. John Hause

Incentive systems which tie promotions, compensation, and other rewards to either quality or customer satisfaction are being embraced by many firms in a variety of industries. Indeed, a majority of U.S., Canadian, Japanese, and German firms believe that it will become their most important criterion in the next three years.[1]

Why all the attention? Do such management and employee incentive systems increase profits? And if so, how? Who should receive incentives? How should short-term (sales) incentives and long-term (satisfaction) incentives be balanced? What is the best way to measure satisfaction, or does it matter? These and other questions are the focus of a multi-year effort at M.I.T.'s Sloan School of Management and the International Center for Research in the Management of Technology.

The effort includes a survey of current practice, the development of theory and procedures, and a test of the theory and procedures with two pilot programs. In one pilot program, a $2 billion manufacturing firm is implementing customer satisfaction programs in some U.S. and European markets but not others. They are seeking to measure the increased profits, if any, that result from the program. In another pilot, a services firm is implementing an incentive program among telephone managers. They are seeking to measure any changes in managerial behavior and any impact on profit.

(The figure indicates some measures and interrelationships for the customer satisfaction systems that the team is studying.) The programs have been chosen to yield insights that are generalizable to many applications.



To analyze the pilot programs, the M.I.T. team developed a formal theoretical model. The model is based on some simple premises:

- Customer satisfaction is a multi-year issue—a firm (or its employees) takes actions today that affect purchasing behavior in the future.
- Customer satisfaction is a competitive weapon (dissatisfied customers are more likely to purchase from competitors).
- Customer satisfaction measures indicate future profit potential (more satisfied customers will buy more, buy more often, buy at a higher price, and/or communicate to others).

In a recent report[2], the team describes why these premises imply that a satisfaction program increases profit, how profitability depends upon employee attitudes, and how the relative emphasis placed on customer satisfaction depends upon the reputations of the firm and its competitors.

For example, why do customer satisfaction incentives increase profits? A satisfied customer is a more profitable customer; investments in satisfying tha customer pay dividends tomorrow. Bu satisfaction at any price may not be profitable. A manufacturer of small

[1]Results reported in *International Quality Study: Top-line Findings*, American Quality Foundation and Ernst & Young, 1991.

[2]J. R. Hauser, D. I. Simester, and B. Wernerfelt, "Customer Satisfaction-Based Incentive Systems," ICRMOT Working Paper, M.I.T., Cambridge, MA 02142, Revised February 1993.

copiers would never dedicate a service rep to every copier sold. A telephone service center should do its best to satisfy customers but not if the costs exceed all revenues. Choosing the right level of service and the right product for long-term profits is a difficult and demanding management challenge.

But employees, even managerial employees, are more short-term oriented than the firm would like. It is only human for individuals, more so than the firm, to discount the future. In fact, short-termism makes sense for managers and employees because they have no guarantee that they will be around to collect long-term rewards. Even if they serve the customer well and the customer remains loyal to the firm, employees may not get credit for future sales to that customer (consider a fast food chain on an interstate highway). The firm may also change the reward system in the future. Thus, if the firm rewards the employee for current sales alone, the incentives of the employee do not match those of the firm.

To overcome short-termism, the firm can reward the employee today for benefits that the firm gets tomorrow—the reward is based on customer satisfaction. However, for such rewards to work, the satisfaction measures must indicate future sales potential and must depend upon actions that managers or employees take. The firm is most profitable when it balances rewards for satisfaction with rewards for sales. Consider a salesperson courting a new account that will be difficult to serve—the account might be profitable today, but the account may not match the firm's core competency. If the salesperson is rewarded on sales alone, he or she will make the sale—even if the account cannot be served well. On the other hand, if the salesperson is rewarded on satisfaction alone, he or she might not make the sale—sales to hard-to-please customers lower the average satisfaction of the salesperson's customers. By setting rewards correctly, firms can signal salespeople how to use their unique knowledge of the customer to make decisions that will profit the firm. Salespeople become true representatives of the firm; by acting in their own best interests, salespeople do what is best for the firm. (The M.I.T. report indicates how to set the rewards.)

There are many other insights in the M.I.T. report. Perhaps the most intriguing are those that relate to current practice. While the right measures (and right rewards) make the firm more profitable, the wrong measures (or wrong rewards) actually decrease profitability.

Customers and noncustomers. Satisfaction measures must be broadened to include those (potential) customers who considered the product and rejected it and those (past) customers who are no longer part of the franchise. Valuable lessons can be learned from these customers, and if their levels of satisfaction or potential satisfaction are ignored, only actions that serve a niche of easy-to-satisfy customers are encouraged. After all, the least costly, but not profitable, way to get a satisfaction score up is to get rid of dissatisfied customers.

Consider precision. Potential customers and past customers may be more difficult to reach. Certainly, their evaluations are either out-of-date or based only on impressions. Such satisfaction measures are inherently less precise. However, the team shows how to consider the precision of the measures and reward more on those measures that are better indicators of future sales or actions that managers or employees take.

Some customers are more equal than others. Some firms use top-box measures, rewarding only for those customers who are very satisfied. Other firms use bottom-box measures, penalizing for customers who are not "somewhat satisfied." Both measures ignore the fact that customers who represent the most profit are those that are in the middle—those customers we might lose without the extra effort and those customers we might win from the competition with just a little more effort. Clearly these profitable customers should not be ignored. Satisfaction efforts should be balanced by selecting rewards that target the customers likely to provide the greatest long-term profitability.

It's all relative. To build a profitable business, firms must satisfy customers better than the competition satisfies them. Improving a service or product may not be enough if the competition improves even more. Benchmarking how competitors' customers perceive competitive products and services yields information which helps manage the business.

Match the measures to the actions. Overall satisfaction is nice, but if employees or managers can do little to affect it, rewards based on that measure will not affect their decisions and actions. The best and most effective satisfaction measures are those that are filtered through the voice of the customer so that every part of the firm understands how their actions affect the customer.

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