

The Service Profit Chain and its relationship to Improved Performance



This white paper looks at the most recent research and proves the relationship between genuinely engaged employees and above average profits. It looks at what organisations can do to achieve genuine competitive advantage through the attitudes and skills of its people.

About us

Established in 1985 and with offices in London, Sydney and New York, Prosell is at the forefront of providing Corporate and SME Clients with proven, objective-led business performance improvement solutions. Our exhaustive knowledge of both business and consumer markets has helped define services aimed at creating and delivering measurable, sustainable improvement for our Clients.

Introduction

In our rapidly changing environment, where Internet technology has significantly diminished the barriers to entry for many industries, the ability to build and sustain a competitive advantage has become increasingly difficult for organisations. Faced with intensely competitive markets and changing buyer behaviours brought on by increased consumption of Internet media, organisations need to acknowledge that it is no longer sufficient to have merely satisfied customers (Chaffey et al. 2006, p. 6).

With the Australian landscape becoming broader and consumers being presented with greater choice, today's customers demand greater value and will only remain loyal if they are completely satisfied (Phil Bonanno, The Leading Edge consultancy 2008).

Extensive research by Jones & Sasser (1995) revealed that in markets where competition is intense, there is a tremendous difference between the loyalty of merely satisfied and completely satisfied customers in terms of financial gains. Given the high levels of competition in the Australian retail sector, companies must raise the level of customer satisfaction from satisfied to completely satisfied in order to secure customer loyalty and generate superior long-term financial performance. Customer purchasing behaviour reveals that merely satisfying customers who have the freedom to make choices is not enough to keep them loyal. Completely satisfied customers are the only truly loyal customers (Jones & Sasser 1995, p. 91).

Achieving this competitive advantage through superior customer responsiveness, however, is not just a matter of doing a better job of delivering the same value or by differentiating based on price. Securing loyal and completely satisfied customers through delivering superior

customer service requires an engaged workforce that is both emotionally and intellectually committed to the organisation (Saks 2006, p.601).

"Only engaged employees exert the necessary levels of discretionary effort that attains loyal customers" (Frank et al. 2004)

Creating and managing an environment where employees exhibit high amounts of discretionary effort in their jobs poses many managerial implications. Discretionary effort implies the additional effort that engaged staff are willing to give. Research by Geary A. Rummel (1998) tells us that up to 40 percent of employee effort is discretionary depending on levels of engagement. This paper will outline and discuss Heskett et al.'s service profit chain (1997), which stipulates a direct and strong relationship between employee engagement and financial performance; and provide research to support the credibility of the model. This paper will then go on to discuss the issues and challenges surrounding employee engagement and discretionary effort, whilst also highlighting the best practices.

Engagement also has a significant impact on employees' intentions to stay with an organisation. Given that much research has supported the fact that employee turnover is a high predictor of employee satisfaction, organisations need to pay considerable attention to managing turnover through engaging their employees, in order to manage customer satisfaction (Hurley & Estalami, 2007).

In closing, the necessary steps to gaining a competitive advantage through developing engaged employees will be explained whilst giving close reference to Prosell's services. It should be noted that the views presented in this paper are not those of Prosell, but are those drawn from the research and statistical proof of

Prosell

104a Willoughby Road
Crows Nest NSW 2065
Australia

17 Penn Plaza 5th Floor
New York City
New York, 1001, USA

6 Oriol Court
106 The Green
Twickenham, Surrey TW2 5AG
United Kingdom

Prosell Australia **1300 559 493**
Prosell United States **1800 484 3089**
Prosell United Kingdom **0870 855 3000**

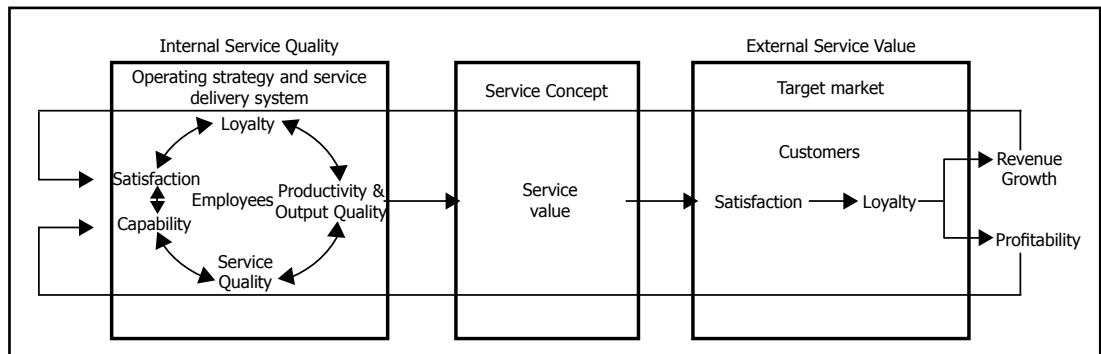


www.prosell.com.au
www.prosell.us
www.prosell.com

Figure 1.0

Service Profit Chain

Source: Heskett, Sasser and Schlesinger, 1997



“Quality work life companies are growing close to 60 percent faster than average S&P 500 organisations”

comprehensive studies. The practices that are outlined here in how to achieve this competitive advantage through people draw on Prosell’s 23 years experience of improving the performance of major companies around the world.

The service profit chain

The service profit chain, shown above in figure 1.0, is a widely recognised model explaining the sustainable competitiveness attained by organisations that have an engaged workforce. The model proposes that growth and profitability are derived from loyal customers who are completely satisfied with the perceived value of the service they receive. That service value is almost always only created by engaged employees that exhibit high levels of discretionary effort because they enjoy the quality of work life provided by the organisation (Lau 2000, p.423).

Quality of work life is defined by the favourable conditions and environments of a workplace that support and promote employee satisfaction by ensuring that rewards, including compensation, promotion, recognition, development, and meaningful work, meet or exceed their expectation (Hackman & Oldman, 1980). Heskett et al (1997) proposed that high quality of work life would create satisfied, committed, and productive employees which in turn would ignite a chain effect leading to an organisations growth and profitability.

In essence, the service profit chain postulates that the satisfaction and loyalty of engaged employees translates into customer satisfaction and loyalty, which in turn generates improved business performance (Pritchard & Silvestro 2005, p. 338).

The service profit chain tested

Heskett et al. (1997) collected empirical evidence from some 20 large organisations giving credibility and support to many of the linkages in the chain; in particular the relationship between employee and customer satisfaction (Silvestro & Cross 2000, p. 246). However, it was not until the exploratory study conducted by Silvestro and Cross (2000) into the strength of the relationships, that any single organisation had been subjected to an analysis of all of the linkages in the service profit chain. The entire model was applied to one of the UK’s leading grocery retailers in order to question the key assumption of the service profit chain, namely, that engaged employees in turn generate customer satisfaction and loyalty. The results showed real and definite correlations between profit, customer loyalty, satisfaction, service value, internal service quality, output quality and productivity.

A separate study by Lau (2000) tested part of Heskett et al.’s model. Lau’s study did not attempt to provide any statistical evidence to validate each individual linkage; but rather it explored the direct linkage between performance in growth and profitability, and quality of work life. This is a proxy for engaged employees in the service profit chain model. Lau’s study indicated that quality of work life and engaged employees had a significant influence on growth and profitability. The study contrasted the performance of companies with a reputation of high quality of work life to a control group of S&P 500 companies.

The results indicated that these quality work life companies indeed did enjoy higher growth rates than those of the S&P 500 companies, and that these differences are statistically significant. On average, the organisations with engaged employees have an average sales growth rate of 23.1 percent, while control group companies have only 14.5 percent, suggesting

that quality work life companies are growing close to 60 percent faster than average S&P 500 organisations (Lau 2000, p. 432). In addition, these companies enjoyed 7.9 percent growth per year for their return ROA (return on assets) while the control group companies had only a 3.7 percent growth, indicating that profitability of the quality work life organisations is growing more than twice as much of the companies in the control group. This research lends much support to Heskett et al.'s notion that quality of work life, which develops engaged employees, creates a chain effect that results in higher growth and profitability.

Pritchard and Silvestro's (2005) research into the service profit chain sought to test the linkages between employee perceptions and performance, customer perceptions and behaviour, and financial performance. The study was based on a UK home improvement store chain. Measures on the relationship between each of the variables in the service profit chain were collected and analysed using Pearson's correlation coefficient. Results indicated service value and quality were correlated positively with employee satisfaction, suggesting employees that are committed and loyal exhibit higher levels of discretionary effort, given that engaged employees create higher levels of service value.

Service value was found to be strongly positively correlated with both customer satisfaction and loyalty. Furthermore, stores with highest loyalty levels were generating the highest perceived service value. This finding validates and supports the central assumption of the model that quality of work life creates engaged employees, which in turn promotes satisfied and loyal customer, translating into growth and profitability. The most significant finding of the study was the strong positive correlation between employee satisfaction and growth. This suggests that employee empowerment and the creation of a positive working environment will generate financial benefits (Pritchard & Silvestro 2005, p. 347).

In conclusion, it would be incomplete of any discussion of the service profit chain to ignore some potential caveats to Heskett et al.'s research and findings. Of prime consideration might be the danger that a total focus on the service profit chain to the exclusion of all else might constrain managements understanding of all the complexities of performance (Pritchard & Silvestro 2005, p. 351). Any generic model needs to be adapted to take into account industry, company size and trading conditions.

However, what is not in doubt is that these studies have revealed many significant performance linkages between variables in the Heskett et al.'s service profit chain model, and have heightened the value of promoting the cooperative efforts between employees and employers. These partnership relationships have been shown to have the dramatic impact of increasing financial performance and competitiveness; revealing the importance of fostering partnership relationships between management and employees.

The saying, "look after your people and they will look after your customers, who will look after your profits, which will look after your shareholders" has never been made more apparent or more clearly demonstrated than through this research.

Employee Engagement & Discretionary Effort

Why is it crucial?

A meta-analysis conducted by the Gallup Organisation concluded that the most profitable divisions of companies have employees doing what they do best, with people they like, and with a strong sense of psychological ownership for the outcomes of their work (Luthans & Peteron 2001, p. 376). Employee engagement; that is where employees are emotionally and intellectually committed to the organisation, is a significant predictor of desirable organisation outcomes including customer satisfaction, retention, productivity, and profitability.

With overwhelming empirical evidence of employee engagement resulting in desirable organisational outcomes, organisations need to recognise the importance of generating and maintaining employee engagement.

A survey of more than 50,000 employees at 59 organisations around the world, conducted by Corporate Executive Board (2004), found that engagement plays a significant role in both the levels of discretionary effort exhibited by employees and their intent to stay with an organisation. As shown in Figures 1.1 and 1.2, engaged employees display up to 57 percent increased discretionary effort and up to an 87 percent reduction in the desire to leave the company.

Figure 1.1

Impact of engagement on the probability of departure

Source: Corporate Executive Board, 2004

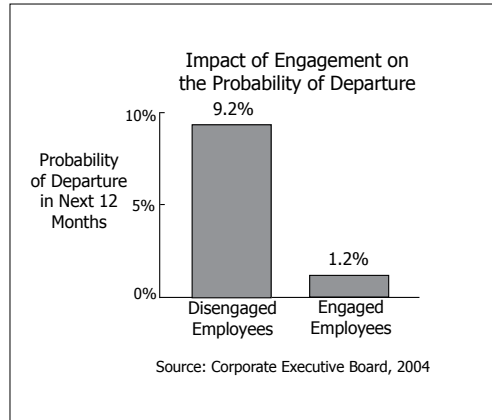
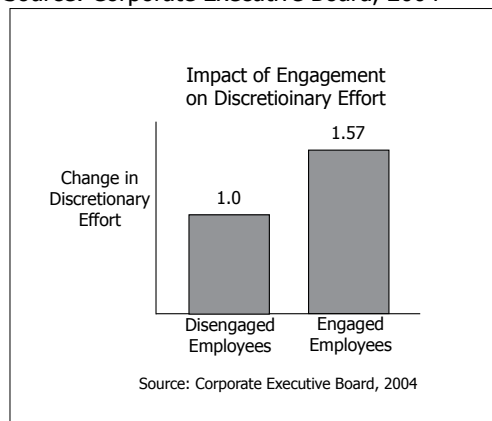


Figure 1.2

Impact of engagement on discretionary effort

Source: Corporate Executive Board, 2004



With the dramatic influence engaged employees have on financial performance and growth being clearly demonstrated by the service profit chain, it becomes evident why human resources and how they are managed deserves increased attention. In particular, Australian retailers facing increasingly competitive markets need to start investing seriously in their core assets; being people (Bonanno, 2008). Employees play a crucial role in transforming an organisation. Motivating employees to contribute their best ability and knowledge in work requires clear and nurturing policies. However, too often management often fails to provide sufficient quality work life.

Organisations need to understand that the development and involvement they provide to all their employees will not only make them more able and more valuable to the organisation, but will also be a powerful incentive for them to stay (Woodruffe 2006, p. 3). Of course there is always the risk that these employees will leave, taking with them their new skills, but management needs to accept that employees are more inclined to leave if they are not

developed. Finding ways for people to want to keep working at your organisation is key to creating an engaged workforce. Engaging talented people should be of utmost importance because these are the people that will keep your customers completely satisfied and loyal.

The increased consumption of Internet media has facilitated a rapid growth in customer feedback websites. The shoppers-of-tomorrow are using Websites such as www.Eatability.com.au; www.Shopping.Yahoo.com.au; or www.Tripadvisor.com to decide where they shop, eat or stay. The extensive reach of these Websites through the Internet has had Prosell see many businesses fall literally overnight as a result of bad feedback being posted. With the impacts of poor quality service being amplified by the characteristics of the Internet, it becomes increasingly evident why having an engaged workforce is so crucial to attaining not only loyal customers, but also delighted customers.

How do we achieve it?

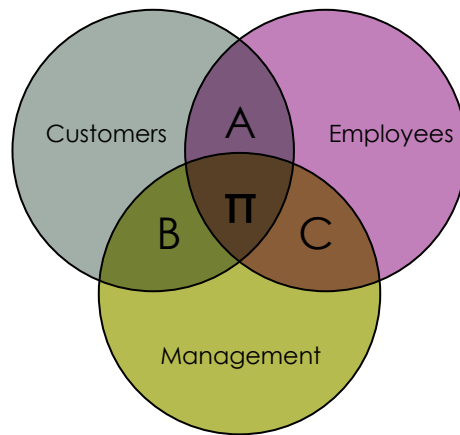
Monetary benefits are typically not the major contributing factor to employee satisfaction or loyalty, though it does play a significant role. The most important factors for employee commitment and engagement are non-financial.

A summary of best practice for retaining and engaging employees was recently given in December 2006 Survey Results "What keeps employees engaged with their workplace?" completed by the Australian Institute of Management and is reproduced here. Many of these conclusions are well known to management. The key is to be able to implement a comprehensive strategy and to be able to measure and correct each element in terms of its contribution to improved profitability.

- Give employees the feeling of working on useful and challenging tasks. Staff that feel no purpose or meaning in their jobs are more likely to leave the organisation.
- Genuinely trust and commit to employees. Trust and affective commitment is important in building relationships. Employees that feel trusted are more likely to feel useful and are more likely to confer loyalty to the organisation.
- Offer good training and development opportunities. Employees that are not developed are more likely to leave the organisation.
- Reward and recognise. Employees like to be valued and recognised.
- Implement strategies that promote positive workplace relationships. Employees that have good relationships with their co-workers and manager are more loyal than those that do not.

Whilst these are effective starting points for engaging employees, these solutions are no more than a start. Achieving an engaged workforce is not always an easy task. It requires the commitment and efforts of management, and a genuine passion for their customers and their staff.

Figure 1.3
Retail Relationships
Source: Prosell, 2008



passion for both staff and customers, which is supported by specific practices.

As shown in Figure 1.3, the three inter-relationships between management, customers and employees are marked A, B and C. Traditionally, organisations have put their focus on relationships A and B. What is too often the case is relationship C is neglected as organisations fail to recognise the importance of developing and involving their staff. However, as much research has indicated, fostering a partnership relationship between management and employees produces significant benefits in terms of financial performance and growth. Prosell's experience tells us that in order to be at n and reap increased profits and growth, we need to measure, manage and constantly improve these three relationships.

There is also an intelligent sequence to the correct events and practices. Everything starts with diagnosis; a process designed to work out 'where we are' with a clear view with 'where we need to be'. From that, specific recommendations on recruitment solutions, policy and procedural structures, measuring and auditing tools, sales and service models, and feedback mechanisms can be made so as to develop a full program design.

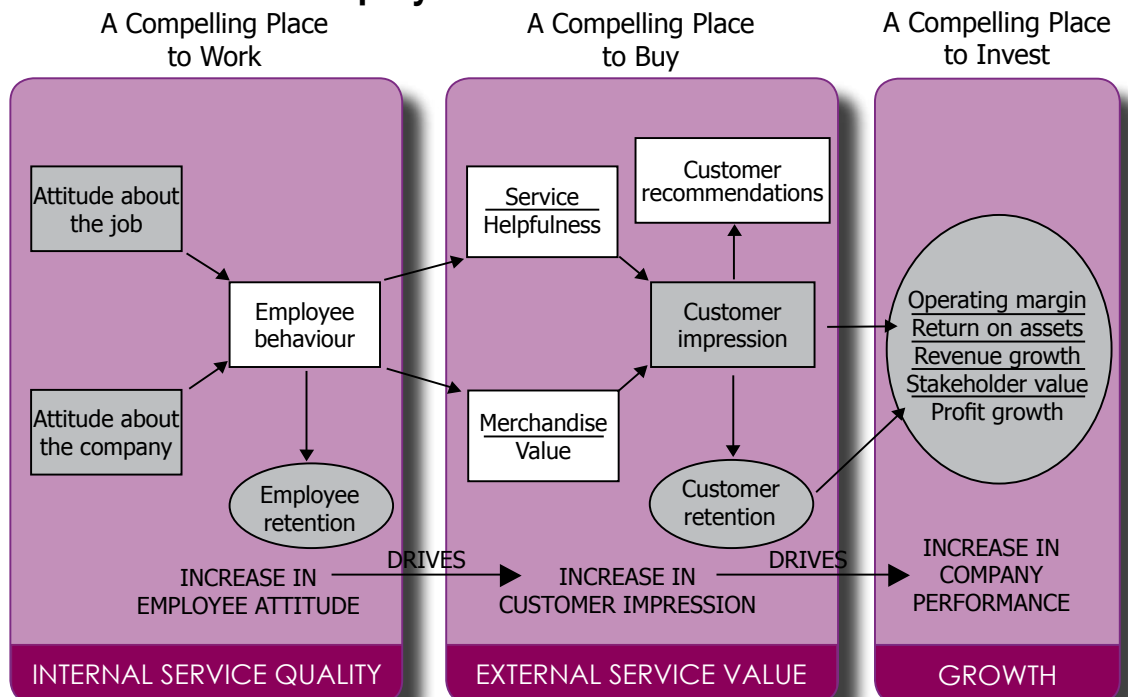
The Journey

The starting point is a commitment on behalf of management to implement a long-term strategy that puts its staff and customers at the centre of their focus. What is needed is a genuine

Following recommendations is the planning of the implementation process. The vision, beliefs and practices of management are evaluated and realigned, if necessary, to be both customer and

Figure 1.4
The employee-customer-profit chain
Source: Adapted from Heskett et al.'s service profit chain, 1997

The Employee-Customer-Profit Chain



employee centric. Champions are identified and nominated, and once a tailored tool kit is developed, a rollout strategy is determined. For this implementation stage to be effective, it is vital that communication is present throughout the whole process. Given this, it is important to understand and improve the attitude of all employees. Attitude surveys are used consistently to give comparisons and add valuable insight.

The performance of the rollout strategy needs to be consistently appraised and reviewed to find out which areas need tweaking and what is not working. Both management and staff need to be involved in this process to determine which parts of the process need to be refined. Internal and external marketing needs to be assessed to ensure that both are congruent. Employees need to be appropriately awarded and recognised. To sustain and maintain this strategy both management and staff must be fully committed. The power of this commitment is ultimately shown when the organisation can use its employee relationships as a powerful PR tool and a point of focus for its executives' media contact.

Shown in Figure 1.4, Prosell have taken the service profit chain concept and adapted it to create a range of tools, measures, training interventions and management practices that gives organisations intelligent implementation methodology.

The areas in grey are those that can be statistically measured and are used as the fundamentals to drive growth. The areas in white are the ones that can be developed and assessed through other forms of data capture.

It is the organisations that recognise that you have to create a compelling place to work, before any initiatives to drive service levels (training, incentives etc), that are the ones that produce above average growth and profit in their industry.

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