Customer loyalty and customer value

Measuring What Matters

By Chuck Chakrapani

"What you measure is what you get"

In 1913, psychologist L.L. Thorndike asserted that "Whatever exists, exists in some quantity; whatever exists in some quantity, can be measured". This assertion provided the rationale for measuring intangible entities like attitudes. A similarly bold assertion was recently made by Robert Kaplan and David North: "What you measure is what you get." They went on to say: "Senior executives understand that their organization's measurement system strongly affects the behaviour of managers and employees. Executives also understand that transitional financial accounting measures like return-on-investment and earnings-per-share can give misleading signals for continuous improvement and innovation – activities that today's competitive environment demand." (*The Balanced Score Card: Measures That Drive Performance*. Harvard Business Review, Jan.-Feb. 1992). In recent years, there has been a concentrated focus on financial measures and on shareholder value. Yet pure financial performance measures are a fight for executive survival. The fight for business survival is fought on a different battlefield: the hearts and minds of customers.

Customers provide the raison d'être of any business. Shareholder value cannot exist on a long-term basis if shareholders are well served but customers aren't. Shareholder value is the consequence of customer value and not the other way round. While it is possible to ignore customer value and manage shareholder value, such a strategy cannot work in the long term.

H. Thomas Johnson makes this point vigorously when he states: "Companies should focus on goals that matter, not on goals that count… accounting goals direct attention to effects not to causes... To achieve the accounting targets mandated by top management, subordinates are left to manipulate processes in any way they think fit. The long term result is unstable processes, unhappy customers and loss of jobs." *(It is Time to Stop Over-Selling Activity Based Concepts*. Management Accounting. September 1992).

Just as measuring customer satisfaction without any reference to the bottom line of a company is counterproductive, so is concentrating on financial measures without reference to customers. The ideal solution of course is to combine both. In the past few years, customer satisfaction, customer loyalty, employee satisfaction, cycle times, innovation and other such measures have been proposed as substitute measures for financial ratios. Adoption of such measures creates problems for those responsible for financial results. How can the company make sure that improvement in non-financial measures will result in improved financial rewards for the organization? What can be done about the missing link – a measure that connects soft (non-financial) measures to financial measures?

Relating strategy to measures

When organizations create performance measures and reward employees on the basis of such measures, the implicit assumption is that such a tactic will not impede the organization's overall strategy. In reality, strategy and performance could be moving in different directions.

Let's consider a high tech company which increases its efficiency by reducing its workforce, reduces prices and maximize customer satisfaction to generate loyalty. All this will influence the bottom line, at least the quarterly or even annual profitability for that year.

But here is the catch. What if the company's long term survival depended not on short-term profitability but on being innovative? Being innovative could mean willingness to spend on research and development that will have a negative effect on short-term profitability. For instance, to maximize short term profitability, new product introductions could be delayed, advertising for a new product could be spread out over a longer period or some employees could be laid off. All such measures will apparently drive performance as it relates to the bottom line. Yet these steps can be highly counterproductive in terms of the organization's overall strategy.

We need to acknowledge that there could be a potential conflict between an organization's strategic goals and the powerful forces that are focussed on performances measures linked to short-term bottom line results.

One reason that measures such as customer satisfaction fail is because they are not linked to bottom line measures or they are linked inappropriately. In fact, even when we have a clearly defined strategy and a list of factors that are crucial to the success of the organization's goals, it is not easy to arrive at the right measures.

Internal contradictions

Part of the problem is the existence of different groups whose objectives are at odds with those of other groups: employees want to be rewarded based on measures that they can control; top management wants performance measures which they can control; shareholders want the market price of the stock to increase. Top management can influence the bottom line (at least for the short term) by cutting the workforce, but this may not be favoured by employees: employees can deliver customer satisfaction but the cost associated with a high level of service may be too high from the management perspective; internal terms may have specific strategic objectives which may not satisfy shareholders' short-term objectives.

Given such internal contradictions inherent in an organization, it is not surprising that different measures are frequently used without thought being given to their integration. This is inevitable since, contrary to the assumption inherent in the use of performance measures, there is no single unifying framework into which such measures can be fit.

Resolving internal contradictions

In recent years, there has been an attempt to reconcile these conflicting objectives and present a unified measurement system that will combine financial and non-financial perspectives of the firm.

What we need is a balanced view, a view that represents all stakeholders of an organization including employees, management, teams, shareholders and customers. In recent years there has been an attempt to move in this direction. Kaplan and Norton's Balanced Score Card exemplifies such an attempt.

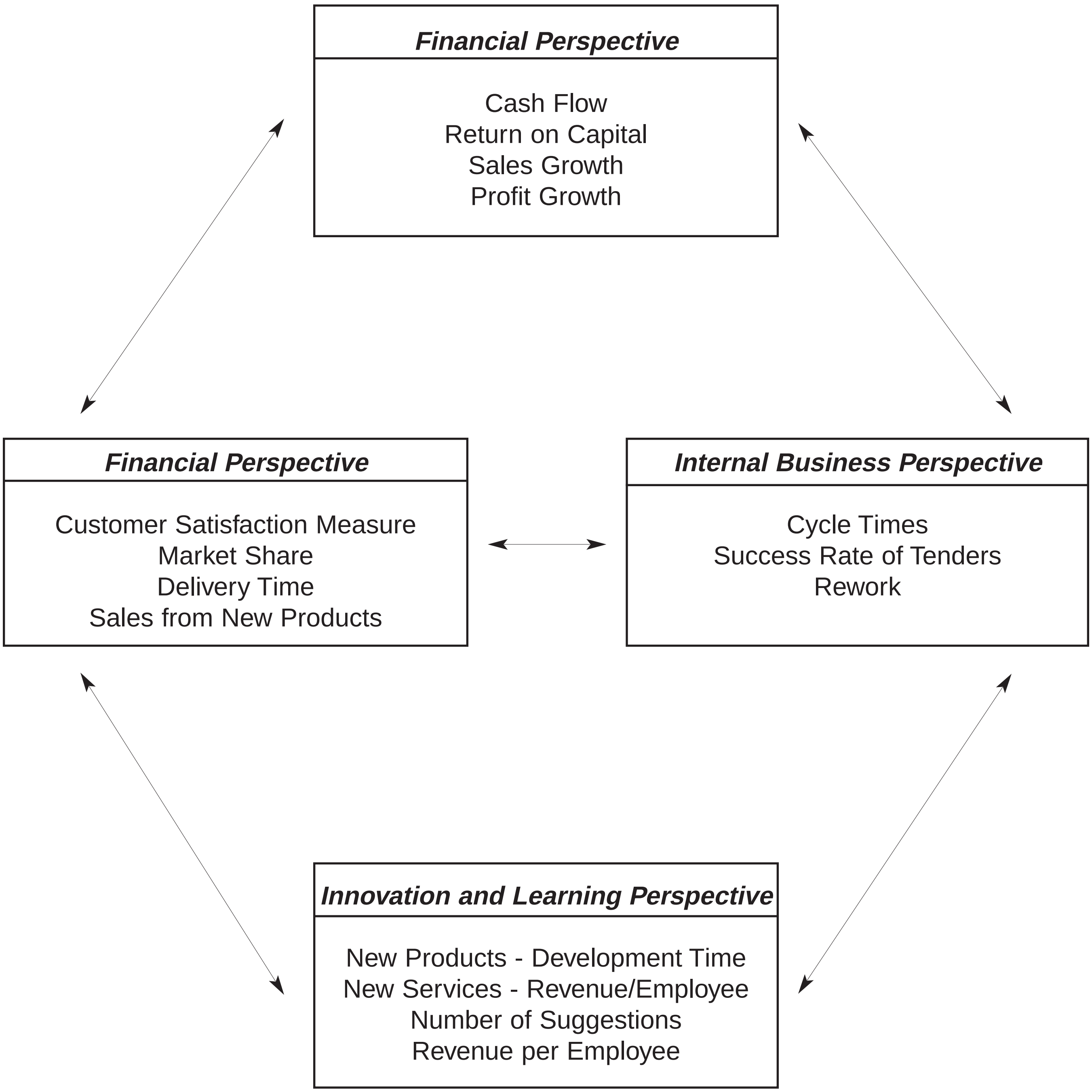
Balanced score card

The underlying concept behind the balanced score card is that different performance measures should be linked to the organization's overall vision and its strategic goals.

Consider, for instance, an organization which wants to deliver exceptional customer service by providing the best value for money. What kind of measurement system would tell us how well the organization has achieved its goal?

Financial perspective. The measures that are obvious to the external world such as shareholders are

Balanced Score Card: An example



A balanced score card represents measures as contributing to a set of inter-related perspectives. It balances external and internal measures as well as financial and non-financial measures.

financial measures such as profitability, and growth in sales. Top management is directly concerned with financial measures as evidenced by profitability and growth.

Customer perspective. But how is an organization to achieve its financial goals? Through providing exceptional customer service and value. This could mean high quality at reasonable cost.

Internal perspective. Quality to customers at the lowest possible cost implies attributes such as streamlined process within the organization, on-time delivery, low defects, and low cycle time.

Organizational learning perspective. What is the framework within which all of these will be achieved? We need an overall vision to achieve the inter-related objectives – a spirit of continuous learning. What is the rate of innovation? How much sales were generated by newly introduced products or services? What impact did new products have on overall profitability?

Distinct but related

These four perspectives – financial, customer, internal and organizational learning – are distinct but inter-related. For instance, internal measures such as innovation and customer satisfaction, are non-financial in nature and yet are related to financial measures. Financial measures, on the other hand, are measures of internal excellence, as judged by the outside world.

When we consider measurements from different perspectives we see that not all of them are financial. Neither are they exclusively non-financial. In reality, financial and non-financial measures have to be balanced. Similarly measures that are relevant to different stakeholders such as customers and shareholders have to be balanced. Hence the description *balanced score card.*

Setting up the balanced score card

Kaplan provides an example of how one company, Rockwater, set up a balanced score card (Analog Devices: The Half-Life System, Harvard Business School, 1990). Rockwater is a worldwide leader in underwater engineering.

Rockwater's mission statement was to lead their industry as their customers' preferred provider. From their mission they derived five strategic objectives: 1. Services that surpass needs; 2. Customer satisfaction; 3. Continuous improvement; 4. Quality of employees; and 5. Shareholder expectations. Based on these five strategic objectives Rockwater developed 20 measures such as cash flow, ROI, safety indicator index, and time spent with customers on new work.

The balanced score card approach developed by Rockwater helped it to establish a process view of operations, motivate its employees and build a stronger and more enduring relationship with its customers.

Compared to earlier measurement paradigms, the balanced score card appears to show great promise.

Dr. Chuck Chakrapani of Standard Research Systems is a Toronto-based consultant who works internationally. His book How to Measure Service Quality and Customer Satisfaction *is published by the American Marketing Association. He can be reached at Chakrapani@cheerful.com.*