

The Effects of Employee Satisfaction on Company Financial Performance

“People are our most valuable asset.” “Our employees come first.” “We’re only as strong as our people.” These declarative statements have been a staple of the American workplace for decades. Yet judging by their routine growth strategies, countless senior management teams seem to be in denial of just how accurate those statements are.

While most organizations typically emphasize generating new business and cutting costs, a rapidly growing body of evidence points to an indirect yet undeniable correlation between employee satisfaction and financial performance—a correlation that has significant ramifications on building profits most effectively. Applied properly, these learnings can also influence how organizations approach a variety of interrelated functions, such as business planning and development, employee rewards and recognition, and even the measurement of ROI.

This white paper outlines the most current findings on the linkages between employee satisfaction and financial performance, including an overview of the latest research, case studies, best practices and source materials.

A New Game with New Rules

“There is one key to profitability and stability during either a boom or bust economy: employee morale.”

—Herb Kelleher, founder of Southwest Airlines

Technology, the increasing global nature of business, regulatory shifts and numerous other factors have emerged over the past decade to change forever how companies compete with each other.

Companies can no longer compete solely on the value of innovation, as products are increasingly commoditized across industry sectors in what is frequently called the *Wal-Martizing* of the marketplace. Most products and services are instantly replicable, making shelf life a fraction of what it once was. Patents are increasingly difficult to defend. It is also harder than ever to compete on manufacturing efficiency, especially when so many other areas of the world possess huge cost advantages when compared to the United States.

In this environment, a key management challenge is to create long-term, sustainable, competitive advantage based on largely untapped points of differentiation. To many CEOs, the challenge feels weighty and unsolvable.

Yet, as a rising number of astute companies have learned, American business has long overlooked and mismanaged one of its most critical assets: human capital. Ample research makes clear that satisfied employees generate demonstrably superior customer satisfaction and that, in turn, satisfied customers are more profitable ones. In other words, creating a work environment with satisfied and motivated employees has been proven critical to achieving profit goals, delivering on marketing promises and competing over the long term.

This concept is gaining attention. *Harvard Business Online* editor Loren Gary writes: “As labor-related costs consume larger portions of shrinking corporate expenditure pies, companies are increasingly motivated to find ways to demonstrate the ROI of their human capital. And some are beginning to do just that.”

Unfortunately, many stock analysts, business pundits and other arbiters of “all things ROI” tend to dismiss issues pertaining to human capital as the “soft stuff” of business. Quite the contrary: The connection between employees and profits is a very real one.

The Evidence: Compelling Research, Tangible Results

“The soft stuff is the hard stuff.”

—Jack Welch, former CEO of General Electric

Jack Welch, the legendary hard-nosed, results-driven, take-no-prisoners CEO, was also a famous believer that communications, human-capital management and other so-called soft issues were vital elements of a growth-oriented business, and that employees are far more than a cost of production.

An impressive body of evidence has accumulated in recent years to indicate that Welch and other CEOs of similar beliefs are correct. Professor Don E. Schultz, one of the nation’s leading authorities on People Performance Management and a faculty member at Northwestern University’s Forum for People Performance Management

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and Measurement, writes that “extensive research on customer satisfaction...demonstrates the link between consumer satisfaction, customer loyalty, and engaged and supportive employees.”

In the book, *The Enthusiastic Employee: How Companies Profit by Giving Workers What They Want*, author David Sirota and colleagues draw on 30 years of research to conclude that enthusiastic employees consistently outproduce and outperform their less satisfied counterparts.

In one example, the authors assessed the stock market performance of 2002 (a bad year in which the S&P declined by 19 percent), analyzing the performance of publicly traded companies whose levels of employee satisfaction they had surveyed in 2000 and 2001. Sirota and colleagues divided the companies into logical industry categories, as well as into one of three “morale categories” based on their research: high morale, moderate morale and low morale.

The results are quite instructive. Companies in the “high morale” category outperformed their industry counterparts by about 20 percent, actually showing a slight increase in stock market value, despite the down market. On the other hand, the “moderate” and “low morale” companies performed about five percent lower than their industry counterparts. Even more enlightening, the findings were similar for other standard measures of company performance, such as ROI and return on assets.

David Maister, author of *Practice What You Preach*, has done comparable research, with very analogous findings. Maister analyzed the financial performance of offices in 29 companies, where he also subjected more than 5,500 employees to 74 detailed questions related to satisfaction and morale. Maister found that “the most financially successful offices did better at virtually everything.”

For 69 out of 74 questions, the average score of offices whose financial performance ranked in the top 20 percent of the analyzed companies was significantly higher than scores for the rest of the offices. For the remaining five questions, their scores were not significantly higher. One of Maister’s primary takeaways was that employee attitudes clearly cause financial results, rather than the other way around.

Arguably the leader in this kind of research is the Forum for People Performance Management and Measurement, the aforementioned organization founded in conjunction with Northwestern University’s Medill School of Journalism to study employees’ impact on organizational performance.

In recent years, the Forum has generated numerous research findings that very pointedly underscore the linkage between employees and company results.

One such breakthrough study, “Linking Organizational Characteristics to Employee Attitudes and Behavior,” makes a clear connection between employee satisfaction and financial performance.

Nearly 100 United States media companies representing 5,000 employees participated in the study. Key findings: Communication was identified as the single key organizational characteristic for explaining employee satisfaction, employee satisfaction is a key antecedent to employee engagement, and companies with engaged employees have customers who use their products more often, resulting in greater profitability.

Unlike many recent studies, the Forum’s study included employees who do not have direct contact with customers, but whose attitudes nonetheless impact the bottom line.

The study’s author, James Oakley of Purdue University’s Krannert School of Management, indicates the relevance of this employee subset by noting that the majority of any sizable company’s employee base doesn’t deal directly with customers. As he told *Workforce Management* magazine, “The linkage is through employees’ impact on customers. There is a relationship between attitude and profitability... that relationship is bridged by satisfied customers. There is a direct link between employee satisfaction and customer satisfaction, and subsequently between customer satisfaction and improved financial performance.”

The idea of a definable link or bridge between employee satisfaction and financial performance is being increasingly documented.

James L. Heskett, UPS Foundation professor of Business Logistics at Harvard’s graduate school of business administration, and his colleagues call this bridge the “service-profit chain.” In a notable *Harvard Business Review* article, “Putting the Service-Profit Chain to Work,” they write, “To excel in a service economy, you must devote most of your time and attention to your customers and the front-line workers who interact with them. Why? Because the lifetime value of a customer can be astronomical.”

In its own summation of Heskett’s article, *HBR* notes a systematic approach to achieving this focus. “Once you’ve quantified the impact of employee satisfaction, loyalty and productivity on the value of products and services delivered, you can build customer satisfaction

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and loyalty. From there, you can assess the impact on profitability and growth. Linking all these measures gives you a picture of the service-profit chain. And understanding the relationships among the links can help you craft comprehensive strategies for lasting competitive advantage.”

Additional examples of recent research in this area abound. For example, management consultant firm Accenture recently commissioned a team of researchers to demonstrate a strong link between human capital development practices and total shareholder return.

This is a particularly noteworthy development, as Accenture represents a non-academic contributor to the growing body of research to articulate the employee-profitability connection.

In addition, Watson Wyatt Worldwide, a human capital consulting firm that studies the value of human capital programs, conducted research of 1,500 companies' HR practices in North America and Europe, the results of which indicated that superior human capital practices are a leading indicator of financial performance.

The study identifies 43 HR practices that have a positive impact on the creation of shareholder value and shows that a significant improvement in those areas is associated with a 47 percent increase in market value. Among the most important contributors were total rewards and accountability, a collegial and flexible workplace, recruiting and retention excellence, communication integrity, focused HR services technology and prudent use of resources.

The clear implication of all of these extensive studies and other studies like them is that the correlation between employee satisfaction and financial performance no longer resides in the realm of the theoretical. The correlation is very real, and understanding that is critical for today's business leaders.

Fortunately, a number of sophisticated business leaders *already* demonstrate an understanding of this correlation, many of which are discussed in the case studies that follow. As is so often the case, several of the companies in this group are poised to blaze a trail for other companies to follow.

Case Studies: Leader Companies that “Get It”

Examples abound of companies that prove the connection between employee satisfaction and financial results. In fact,

the evidence has already been available for a number of years.

Taco Bell In an *HBR* article over a decade ago, Heskett and colleagues found that 20 percent of Taco Bell restaurant branches with the lowest turnover rate enjoyed double the sales and a 55 percent improvement of profit over those stores with the highest turnover rate. In the late 1990s, a five-year detailed analysis of 800 Sears stores by the same researchers also published in *HBR* found a five-unit increase in employee attitude yielded a 1.2-unit increase in consumer impression and a five percent increase in revenue growth.

These kinds of findings are gaining notice among a rising number of sophisticated companies that, in turn, are structuring their own growth strategies around an understanding of the importance of employees in generating profits.

State Farm This insurance giant, Reichheld writes in *The Loyalty Effect*, insures more than 20 percent of the nation's households, and its lead in market share continues to increase. Its agents are well compensated, yet the company's sales and distribution costs are historically low. Above all, State Farm does a notable job in retaining shareholders.

How has the company achieved this? As Reichheld notes, State Farm's success can be traced back to a loyalty-based system that “puts measures, incentives, agent selection, training, career paths, customer acquisition, product line, advertising, pricing, service levels and all other company functions into the service of value and loyalty.” As a result, State Farm agents tend to stay with the company longer than agents at competitor companies and, because of their satisfaction levels, are far more productive. And productivity is a clear link on the service-profit chain defined by Heskett.

American Standard This global company is another case in point. American Standard has market-leader businesses in three diverse areas: air-conditioning systems and services, bath and kitchen products and vehicle control systems.

A 2003 study by Accenture points out that the company itself credits much of its success to “a dramatic improvement in its ability to develop and manage people.” In transforming itself from a collection of companies into a unified corporation that leverages marketing channels and

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technologies, the company increased revenues and saw its stock price climb by more than 40 percent.

In an article bylined by Accenture's Peter Cheese and Robert J. Thomas, American Standard senior vice president of HR Larry Costello says, "We have changed our company's performance because of our emphasis on human capital. This emphasis has enabled us to achieve an edge over our closest competitors." Based on its early and immediate success after sharpening its focus on its personnel, American Standard has continued to evaluate its systems and processes to identify new ways to better leverage its employees in order to enhance satisfaction and, consequently, increase profits.

Southwest Airlines As one of the airline industry's most profitable and popular competitors for more than two decades, Southwest has succeeded in a difficult environment that has many other carriers struggling to survive. Former CEO Herbert Kelleher's philosophy is a simple yet powerful one: "Anyone who puts things solely in terms of factors that can be quantified is missing the heart of business: people."

Southwest is consistently ranked among the best places to work and enjoys huge employee satisfaction and retention levels, enabling the company to remain profitable for nearly 25 years. If the company gets *anything* wrong, it is the idea, suggested by Kelleher, that the value of people can't be quantified. There is increasing evidence to the contrary: Their value *can* be quantified. And by putting in place a system that emphasizes employee satisfaction in order to maximize customer loyalty, Southwest is poised to reap profits for years to come, even as other airlines no doubt contend with bankruptcies and employee revolts.

Ritz-Carlton Finally, one of the "poster children" for companies that recognize the importance of employees to ultimate business success is the hotel giant Ritz-Carlton.

In a report from The Forum for People Performance Management and Measurement that links employee engagement to profitability, Sue Stephenson, the hotel's senior vice president of HR, points out that even employees who have no contact with guests affect the company's financial success.

"The employee washing dishes or cleaning silver never interacts with the customers in the restaurant, but they understand their role, which is that the cleanest dishes and

shiniest silver will help create a great culinary experience in the restaurant."

Ritz-Carlton constantly reinforces to employees how they contribute to satisfying customers, and thus generating profits. Hotel management frequently holds beginning-of-shift "pep rallies" at which exceptional customer service stories are shared. In addition, every employee has the green light to expend up to \$2,000 to "delight a guest" who has had a customer-service issue. Strong compensation and rewards are also a large part of the Ritz-Carlton mix.

The approach is clearly working for the upscale chain. While its profits are strong, the hotel group has lowered its turnover rate from 51 percent in 1991 to slightly above 23 percent in 2004.

Strengthening the Employee Satisfaction/Profitability Chain

The ample research results and anecdotal evidence both lead to the same, inevitable conclusion: The link between employee satisfaction and financial results is a very real and tangible one and represents one of the few remaining opportunities for competitive advantage.

How do companies strengthen that link in such a way that employee satisfaction translates to customer satisfaction, which in turn leads to better profitability?

Following are *10 Common Characteristics of Companies that "Get It"*:

1. **They have principled leadership.** This doesn't mean *ethics* per se, although, certainly, ethical behavior is an integral component of a strong foundation for employee satisfaction. Rather, it means that company management makes a long-term commitment to employee engagement and satisfaction an indelible part of the organization's DNA—not something to be cut or de-emphasized when times are tough.
2. **Management listens and responds.** At these companies, management has its finger on the pulse of its employee population. It elicits their input, values it and makes changes based on it. After all, no one is closer to the customers than the employees.
3. **They have strong reward and recognition systems.** Customer service departments at telecommunications companies usually have a bad reputation. But not T-Mobile's customer care group. Why? Because the company implemented a well-conceived incentive program, with rewards and recognition the employees

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care about. As a result, motivation has never been higher at T-Mobile.

4. Individual and organizational goals are defined, and understood.

Employee motivation and satisfaction is nearly impossible to generate if employees don't understand—and care about—how their jobs contribute to the greater good of the organization, and to the good of the organization's customers. Smart companies establish those links in a very articulated manner.

5. **They emphasize training.** Regular and relevant training energizes employees at all levels and ensures that they have the necessary skills to compete—and to help the company compete. This ranges from training senior managers to become better coaches to training mailroom staff technology skills.
6. **They link the internal to the external and vice versa.** Many companies view internal and external messaging as distinctly different animals. They're not. Companies hoping to build an employee base that expends all of its thinking and effort on achieving external goals must put into place an integrated marketing program that reflects all constituencies, both inside and outside that company. No company can keep its external promises without preparing its employees to keep them!
7. **Communication, Communication, Communication!** Open and frequent lines of communication are critical to building a strong link between employee efforts and external goals, to building satisfaction among both employees and customers.
8. **Measurement, Measurement, Measurement!** Companies with a highly evolved sense of the employee-to-customer-to-profitability chain constantly measure everything: customer satisfaction, employee satisfaction, process efficiencies...everything. This enables them to determine what's working and what's not, and to make adjustments accordingly. Periodic re-evaluation also enables their company to benefit from an influx of fresh ideas and new perspectives.
9. **They empower employees to act in the customers' best interest.** How many times have you been in a customer-service situation where you're frustrated, both by the inconvenience and the fact that the employee you're dealing with is clearly powerless to do anything about it because of the "rules?" Yes, rules are important. But, contrast that experience with what you would encounter

at a Ritz-Carlton, where the employee is empowered to make your problem go away on the spot. Which company would you spend your money at again?

10. They care about the short-term, but manage against the long-term.

Time and again, research indicates that companies with a long-term commitment to clearly stated goals build a greater degree of employee satisfaction than companies who shift priorities on the fly. This commitment to the long-term encourages employees to remain employees, and strengthens their ability to contribute to your financial performance year after year.

Conclusion: Where do we go from here?

Today, the linkage between employee satisfaction and financial performance is undeniable, based on numerous studies that support the correlation. As a result, companies have a rare opportunity to gain competitive leverage and differentiation by harnessing their greatest asset: their employees. Employees, in fact, are the most critical point of differentiation for any company in today's business environment.

The correlations are clear: Satisfied employees generate satisfied customers, who in turn build long-term relationships—and spend more money.

This presents a tremendous finding for American corporations, most of which do not maximize the power of their employees. A major survey conducted by the Public Agenda Forum indicates that fewer than 25 percent of American workers are working to their full potential. And 75 percent said they could be significantly more effective in their jobs than they are. Plus, 60 percent believe they don't work as hard as they did in the past.

These are certainly not the characteristics of satisfied, engaged employees. With stronger leadership and a workplace that understands and values the power of employees to impact financial results, the possibilities for growth are endless.