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# LINKING SERVICE ENCOUNTERS TO FINANCIAL PERFORMANCE: AN EXTENDED APPROACH TO VALUATION

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ABSTRACT OF DISSERTATION

Carla Yvonne Childers

The Graduate School  
University of Kentucky  
2009

LINKING SERVICE ENCOUNTERS TO FINANCIAL PERFORMANCE:  
AN EXTENDED APPROACH TO VALUATION

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ABSTRACT OF DISSERTATION

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A dissertation submitted in partial fulfillment of the  
requirements for the degree of Doctor of Philosophy in the  
College of Business and Economics at the University of Kentucky

By  
Carla Yvonne Childers

Lexington, Kentucky

Director: Dr. Scott W. Kelley, Gatton Endowed Professor of Marketing

Lexington, Kentucky

2009

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## ABSTRACT OF DISSERTATION

### LINKING SERVICE ENCOUNTERS TO FINANCIAL PERFORMANCE: AN EXTENDED APPROACH TO VALUATION

Managers and researchers have become increasingly interested in linking marketing activities to firm financial performance. That is, they desire to make marketing more financially accountable. One approach to achieving this goal has been to “value” customers to determine their degrees of profitability over the lifetime of their relationships with firms. However, traditional customer valuation techniques are largely based on quantitative factors and do not account for softer measures such as a customer’s behavior and performance both during and after service encounters.

Additionally, while customer profitability is commonly valued, employees are not generally assessed in this manner in profit linkage frameworks. This indicates that employee factors have not been deemed to have an equivalent, direct impact on the bottom line. Instead, if included at all, employee factors have mainly been positioned as antecedents to customer factors in past linkage models. Because both customers and employees play essential roles in determining the success of service encounters, both customer and employee factors should be fully considered before profitability is determined.

In this dissertation, an innovative theoretical model is presented in which past profit linkage research is extended to include nonfinancial considerations. This research merges traditional financial valuation methods with nonfinancial metrics to assess organizational performance. Furthermore, a conceptually parallel framework is developed in which both employee and customer factors are hypothesized as links through which service encounter dynamics can be connected to firm financial performance. This research examines the linkages between service interactions, customer and employee outcomes, and overall financial performance.

Within the contexts of two studies, the overall structural model is dissected into comparable performance models and examined within the retail banking and computer services industries. The overall empirical findings provide some evidence of a positive flow of interconnected relationships between service encounter dynamics and firm financial performance. Accordingly, this research presents some indication of the importance of service encounters as antecedents to outcome behaviors that have critical financial consequences.

KEYWORDS: Service Encounter, Profit Linkage, Customer Lifetime Value,  
Customer Equity, Employee Equity

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*To God be the glory for the things He has done.*

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## CHAPTER ONE:

### INTRODUCTION

In recent years there has been a call to increase the financial accountability of the marketing function within organizations (Ambler 2003; Bolton 2004). As marketing practitioners have struggled to quantify their contributions to firm performance (Lehman 2004; Webster, Malter, and Ganesan 2005) marketing academicians have increasingly taken on the task of addressing this issue. In fact, the Marketing Science Institute has consistently listed financial accountability among its top research priorities for several years (1998, 2000, 2002, 2004, and 2006). This research call has sparked the development of a variety of models referred to as “linkage models,” “performance-based frameworks,” or “enterprise performance models” (Payne, Holt and Frow 2001). In these models, a diversity of marketing constructs have been “linked” and tested in relation to a firm’s bottom line. Perhaps the best known example of a linkage model is the service-profit chain (cf., Heskett, Sasser, and Schlesinger 1997). This research has also been referred to as “marketing performance measurement” (e.g., Clark and Ambler 2001; O’Sullivan and Abela 2007).

Many early profit linkage models focused mainly on tangible data reported in a firm’s financial statements (cf., Aksoy, Cooil, Groening, Keiningham, and Yalcin 2008). However, as practitioners and researchers discovered that purely financial metrics were insufficient in justifying marketing investments (cf., Rust, Ambler, Carpenter, Kumar and Srivastava 2004), marketing researchers have increasingly recognized the need to include intangible and nonfinancial metrics in financial performance assessments (e.g., Aksoy et al. 2008; Clark 1999; Gupta, Lehmann, and Stuart 2004). Thus, there has been a further call to extend profit linkage research to include nonfinancial considerations (Clark 1999; Marketing Science Institute 2000). One of the objectives of the current research is to address this call.

Marketing researchers have long regarded the exchange as the central tenet of marketing activities. However, thus far, analyses of the exchange have not been included in profit linkage research. For services, the actual interaction between the customer and provider is essential to the exchange process. Therefore, the current research examines

exchange via service interactions within a profit linkage framework. Specifically, this research examines the intangible and nonfinancial dynamics of service encounters to determine their impact on a firm's bottom line.

A service encounter is “the dyadic interaction between a customer and service provider” (Surprenant and Solomon 1987, p. 87), or “a period of time during which a consumer directly interacts with a service” (Shostack 1985, p. 243). Service encounters consist of both economic and social elements given that economic exchange is carried out within the context of social exchange (Czepiel 1990). Because most service encounters require interactions between customers and providers, social factors can be readily observed and analyzed during these interactions. Furthermore, these interactions can be assessed to determine if they carry economic consequences. Thus, service encounters present a valuable opportunity to examine the effects of both customer and employee factors as antecedents to firm financial performance.

#### *Overview*

In this dissertation, an innovative conceptual model is presented in which past profit linkage research is extended to include nonfinancial considerations. This research merges traditional financial valuation methods with nonfinancial metrics to assess organizational performance. More specifically, this research examines the linkages between service interactions, customer and employee outcomes, and overall financial performance.

In the chapters that follow the components of the conceptual model are discussed in further detail. In Chapter Two, a review of past service encounter and profit linkage literature is provided. In Chapter Three, the research model is introduced along with a review of the constructs included in the model and their hypothesized relationships. In Chapter Four, the methodologies for testing the research model are presented. In Chapter Five, the results of the data analyses from two studies are discussed. Finally, in Chapter Six the conclusions and implications of the dissertation are provided.

In the current chapter, the overall premise will be set for the introduction of an extended approach to valuation. This chapter establishes the purpose of and need for this research, identifies past research gaps, provides a description of the research, and identifies the intended research contributions. The discussion begins with background information.

## Background

A special section in the October 2004 issue of the *Journal of Marketing* addressed the Marketing Science Institutes' promotion of interactions between marketing academicians and practitioners with the goal of linking marketing activities to financial performance and firm value (cf., Bolton 2004). The articles in this special section addressed such issues as how to use customer lifetime value as the basis for evaluating marketing spending (Venkatesan and Kumar 2004), and the link between customer satisfaction and shareholder value (Anderson, Fornell and Mazvancheryl 2004). As the field of marketing increasingly became customer-centric (Vavra 1997, pp. 6-8), the customer became the key element in the link between marketing activities and financial performance. In view of this fact, both scholars and practitioners have developed major interests in creating strategic methods for valuating customers (e.g., Lewis 2005), establishing profitable lifetime customer relationships (e.g., Reinartz and Kumar 2003; Dwyer 1997), strategically managing those customer relationships (e.g., Ryals 2005; Bowan and Narayandas 2004), and satisfying customers through strategic investments in service quality (e.g., Rust, Zahorik, and Keiningham 1995).

In addition, researchers have also been interested in linking employee factors to financial performance. For instance, employee performance of organizational citizenship behaviors has been found to positively affect overall organizational success (e.g., Podsakoff and MacKenzie 1997), and employee turnover intentions have been posited to negatively affect the bottom line due to increased hiring and training costs or lost sales and customer bonds (e.g., Russ and McNeilly 1995). Researchers have also examined the relationship between employee job satisfaction and firm financial performance (e.g., Abbott 2003; Schneider, Hanges, Smith and Salvaggio 2003). Both direct and indirect relationships between employee factors and financial performance have been established.

While both customer and employee factors have been linked to firm financial performance, the financial impact of the interactions between the two has not been previously examined. Specifically, past research has not included the impact of the behavior and performance of customers and employees during service encounters on firm financial performance. In recent years, researchers have recognized the need to link service and financial performance (e.g., Anderson 2006; Rust and Chung 2006). Because service encounters are core elements of service, linking the service encounter to financial

performance provides a major step in advancing service research. In the current research, this link will be developed through the use of valuation techniques.

Most popularly, the term “valuation” is used in finance and refers to the determination of the economic value of an asset or liability (e.g., Realdon 2007; Wallace 2008). In the current research, the term “value” (similar to “valuation”) means to assign value to or appraise the quality, ability, performance, or significance of something (in this case an individual). Managers and researchers have increasingly taken on the task of valuing customers to determine their degrees of profitability. However, in the past, customer valuation techniques have been solely financial in nature. Specifically, while firms have recognized that some customers are simply unprofitable and have devised strategic methods for serving or not serving them, they have neglected to consider many nonfinancial factors that may actually still affect the bottom line in the long run. Firms like FedEx, U.S. West, First Union, Hallmark, GE Capital, Bank of America, and The Limited have used profitability as a yardstick for segmenting customers and as a result decided to provide more services for profitable (i.e., good) customers and fewer services for less profitable (i.e., bad) customers (Zeithaml, Rust and Lemon 2001). The current research proposes that the financial factors traditionally used to categorize customers as good/bad are too limited and should be expanded to include nonfinancial considerations of service encounter dynamics before profitability is determined.

In marketing research, valuation techniques have primarily been used to value customers (e.g., Jain and Singh 2002; Reinartz and Kumar 2000; Rust, Lemon and Zeithaml 2004). Unlike customers, employees have not traditionally been included as assets in valuation research. In practice, an employee’s worth has sometimes been established purely based on the financial results of his or her performance (e.g., through the use of sales quotas). However, outcome-based only employee performance measures do not reveal the entire scope of an employee’s equity to the firm. A more complete measure of employee performance would also include an assessment of employee behaviors and activities during service delivery (Hoffman and Ingram 1992). For instance, through the performance of activities such as organizational citizenship behaviors and through an employee’s organizational commitment, he or she may become more valuable to the firm. Thus, employee behaviors and performances may be viewed as financial resources. Overall, because employees play an essential role in impacting

financial performance, they should be valued to determine their equity to the firm and employee factors should be given the same degree of consideration in valuation research as customer factors. The current research includes employees and employee factors in a profit linkage framework.

### Research Gaps

Despite the growing interest in profit linkage research, gaps continue to exist in the link between service and financial performance. According to Anderson (2006, p. 587), “perhaps the single most important step for future research is to develop a coherent body of knowledge that links service and marketing efforts to financial outcomes and models.” The current research addresses four research gaps in the service encounter and profit linkage literature. These gaps include the shortage of nonfinancial metrics in valuation procedures, the lack of a full consideration of the influence of service encounter dynamics including the overall missing link between service encounters and financial performance, the exclusion of employees in the customer valuation process, and the omission of employees as direct assets in profit linkage models.

The first research gap concerns the need to include nonfinancial metrics in financial valuations (cf., Clark 1999; Marketing Science Institute 2000). While marketing researchers have increasingly focused on addressing this need (e.g., Aksoy et al. 2008; Gupta and Lehmann 2003; Rust et al. 2004), several nonfinancial measures have yet to be examined. The current research examines the impact of the nonfinancial, interactional elements of service encounters along with other nonfinancial customer and employee factors to establish links to firm financial performance. Ignoring nonfinancial factors could result in flawed marketing investment decisions. For instance, firms sometimes segment their customers and allocate marketing resources to them based on their levels of profitability. However, traditionally, profitability segments have been based solely on the financial aspects of relationships with customers. It is likely that nonfinancial factors such as a customer’s behavior and performance during service encounters may also influence the bottom line. Thus, the reliance on financial data alone in customer valuations presents an inadequate view of the overall quality of the customer. Nonfinancial factors should be included in linkage research to provide a more complete assessment of the elements within the chain of effects.

The second research gap involves the need for a more thorough investigation of service encounter dynamics in marketing research. The events occurring during service encounters have vital implications for overall firm performance; however, researchers have not traditionally incorporated service encounter dynamics into research models (for an exception see Woodside, Frey and Daly 1989). Service encounters can be dissected to reveal the specific events that affect the attitudes and behaviors of encounter participants (Woodside et al. 1989). This information is important because as mentioned previously, the outcomes of service encounters (e.g., satisfaction, loyalty, etc.) have been shown to impact financial performance. Thus the interaction between the customer and the service provider is a precursor to several critical service outcomes.

In addition, past research has not attempted to link service encounter dynamics to firm financial performance. That is, constructs included in valuations and profit linkage models such as customer satisfaction (e.g., Aksoy et al. 2008; Anderson et al. 2004), employee satisfaction (e.g., Bernhardt, Donthu, and Kennett 2000; Heskett et al. 1997) and customer lifetime value (e.g., Gupta et al. 2004; Venkatesan and Kumar 2004) have mostly been linked to financial performance without regard to the actual events occurring during the interaction between the customer and the service provider. This is problematic because past research does not provide a full representation of what it takes to achieve financial success. If the encounter is unsuccessful, the bottom line will not benefit. For example, customer equity calculations are mainly based on the amount of money a customer spends with a specific firm over time. This generally represents the link between customer loyalty and financial performance. However, bad customer behavior during the service encounter may come with costs (e.g., employee dissatisfaction leading to turnover) that actually make the customer less valuable despite his or her loyalty. Thus, service encounter events may be important antecedents to a firm's financial performance.

An additional research gap exists where past models have not included employees in the customer valuation process. While a few researchers have included employees in the generation of service encounter quality survey items (e.g., Jayawardhena, Souchan, Farrell, and Glanville 2007; Raajpoot 2004) employee's opinions of customer behaviors during encounters have not yet been incorporated into research models. Because front-line service employees interact directly with customers, they are likely to gain a more holistic view of the quality of a customer. For some employees, bad customers might

simply be individuals that complain too much, behave rudely, are too time-consuming, withhold information, communicate poorly, demand too much, or distribute negative word-of-mouth. These characteristics may negatively impact employee job satisfaction, firm reputation, and/or tie up too many company resources, which may ultimately affect the bottom line. On the other hand, good customers might simply be individuals that are polite, knowledgeable, fun to interact with, provide feedback, allow employees to do their jobs, are open-minded, and provide positive word-of-mouth. Even though customers with these characteristics may not always be the biggest spenders, they may contribute to a pleasant working environment for employees, generate new business, and make innovative suggestions for improvements, which may also affect the bottom line. However, managers involved in executing customer valuations are not generally exposed to customers during encounters and therefore rely on purely financial measures. Thus, first-hand employee perceptions of the value of a customer might prove to be helpful in making more accurate customer valuations and in determinations of customer profitability.

A final research gap involves the omission of employees as assets in profit linkage models. While past studies have considered customers to be intangible firm assets and have therefore included customers in profit linkages, employees have not been considered in this manner. Traditionally, managers and researchers have failed to acknowledge the full profit potential of employees (Grant and Schlesinger 1995). For instance, long-term employees create value for a company because they are more familiar with the business and they often build profitable relationships with customers (Reichheld 1993). Long-term employees may also be more committed to organizational goals and more willing to perform tasks that contribute to organizational success. Thus, in some cases employees, in and of themselves, may actually provide an additional channel of equity for firms. Employees that are committed to their organizations and provide superior performance during service delivery should be considered assets to the firm and included in profit linkage frameworks.

In general, past profit linkage models have been unidirectional with the only employee constructs portrayed as independent variables with customer constructs as their outcome variables (e.g., the service-profit chain). These models do not account for the additional, direct flow of effects from employee factors to firm financial performance. A better research model would be one in which customer and employee constructs somewhat

“mirror” each other. That is, a more symmetrical approach to profit linkage would account for the fact that both customer and employee factors are equally important and would represent the twofold impact of service encounter outcomes on firm financial performance.

#### Statement of the Problem

In answering the call for financial accountability, marketing researchers have developed several performance measures primarily focused on financial metrics (Rust et al. 2004). However, many nonfinancial factors have also become increasingly important (Aksoy et al. 2008; Clark 1999). Within the service context, many important nonfinancial factors can be observed during service encounters. These factors are likely to have financial consequences. Nevertheless, factors resulting from interactions between customers and employees have been overlooked in equations of firm performance. Hence, the basic research question to be addressed in the current study is:

Do interactions between customers and employees lead to outcomes that influence a firm’s financial performance?

To address this question, the dynamics of service encounters must be examined as antecedents of customer and employee outcomes and indirectly linked to firm financial performance through effects on employee and customer factors. The results of this research should provide a more comprehensive understanding of the impact of service experiences on firm financial performance.

#### Study Description

The current study seeks to address the above-mentioned research gaps by expanding past profit linkage research to include the elements of the service encounter as antecedents to a flow of linkages to firm performance. In this research, a broad conceptual model is developed and then examined in pieces with the customer and employee factors tested separately to establish a direct flow of effects from each party in the service encounter to firm financial performance. That is, this research develops a parallel framework in which both employee and customer factors are hypothesized as links through which service encounter dynamics can be connected to firm financial performance. The employee and customer factors are designed to conceptually “mirror”

each other. In particular, the constructs of interest represent both the financial and nonfinancial factors that influence customer and employee value.

While past research has considered primarily financial valuations of customers, the current study aspires to incorporate both financial and nonfinancial characteristics into value assessments. By exploring how customers behave and perform during service encounters, the current research provides a more thorough appraisal of customers before presuming customer profitability. Additionally, while past profit linkage frameworks have neglected to account for the importance of employees as assets, the current framework accommodates the need for the inclusion of employee variables and the assessment of employee equity to the firm.

Finally, the current research seeks to expand service encounter research by linking service encounter phenomena to firm financial performance and by including the service encounter as a variable in the research model. The study is designed to enable a full consideration of the interactional aspects that eventually influence economic outcomes. While it may be obvious that the outcomes of service encounters influence financial performance, in this research, perceptions of encounters themselves are examined to uncover strategies that may enhance the service delivery process and ultimately firm performance.

#### Contributions

Understanding the dynamics of service encounters has huge implications for managers. According to Solomon, Surprenant, Czepiel, and Gutman (1985, p. 101), “the ability to identify mutually satisfying factors in encounters will be helpful in the design of services, in the setting of service level standards, in the design of service environments, in the selection, training, and motivation of service providers, and in guiding customer behaviors”. As key determinants of firm success, the interactions between customers and employees must be fully examined to gain an understanding of their impact on the bottom line. The primary intended contribution of the current research lies in its introduction and assessment of a comprehensive profit linkage framework based on a flow of effects from the service encounter to firm financial performance. This research builds on past profit linkage research to include nonfinancial considerations of service encounter dynamics and customer and employee outcomes. The current research accounts for the nonfinancial

service-oriented factors that substantiate in financial outcomes. Thus far, managers and researchers have not estimated financial performance in this manner.

The current research contributes to the profit linkage literature by separating the lineage of customer and employee factors into parallel chains of variables that impact firm performance. This separation enables a more thorough determination of which factors really impact the bottom line when taking into account service encounter dynamics and both parties to the interaction. In addition, the current research contributes to the service encounter literature by expanding the effects of encounters beyond customer and employee outcomes to create an overall link to financial performance. This research also enhances the service encounter literature by considering service interactions to be important factors that should be included in empirical models.

In addition, the current research makes an overall contribution to the marketing literature by accepting the challenge of making marketing activities more financially accountable. The activities and events that occur during service encounters may provide insightful information concerning how financial outcomes are ultimately achieved. From a managerial perspective, this research should also improve decision-making regarding customer and employee valuations. As managers attempt to determine which customers to serve, how to serve them, and how to properly manage employees, they will be equipped with a more thorough account of each customer and employee's overall value to the firm. Rather than making shortsighted decisions based solely on economic factors, this research will provide managers with a more complete picture of the elements that are necessary for ensuring financial success.

#### Chapter Summary

Chapter One has provided an overview for research aimed at extending the traditional approaches to profit linkage assessments. This chapter has established the purpose of and need for the current research, identified past research gaps, provided a description of the overall dissertation, and identified the intended research contributions. In the next chapter, a review of past service encounter and profit linkage literature is provided.

## CHAPTER TWO: LITERATURE REVIEW

### Introduction

In recent years, marketing researchers have stressed the importance of linking service efforts to financial performance (cf., Anderson 2006; Rust and Chung 2006). The current research seeks to link service activities and financial performance by examining the financial impact of service encounters. The purpose of this chapter is to provide a review of both the service encounter and profit-linkage literatures. This chapter establishes the conceptual basis for linking service encounters to financial performance.

### Service Encounters

Interactions between customers and service providers are essential to the functioning of many service organizations. During these interactions (i.e., service encounters), customers and service employees “co-create” products (i.e., services) in a manner that is highly unique in comparison to goods manufacturing. For instance, in goods-producing industries, customers rarely interact with organizations. However, in service industries, customers must often be physically present to facilitate the exchange process. This issue of inseparability between customers and employees necessitates the designing and managing of service encounters in a manner that is satisfying to both parties and that accounts for each of their perspectives.

Past research has offered varying definitions of the term “service encounter”. Some of the variation in the definitions can be explained by differences in service situations and service environments. For example, while many services are delivered through face-to-face interactions between customers and service providers, others may involve customer-to-machine transactions in which the customer interacts with the service but not necessarily with the service provider. These differences are apparent in the frequently cited definitions of “service encounter” provided in Table 2.1.

It is most commonly agreed that a service encounter is “the dyadic interaction between a customer and service provider” (Surprenant and Solomon 1987, p. 87), or “a period of time during which a consumer directly interacts with a service” (Shostack 1985,

TABLE 2.1

## Frequently Cited Definitions of “Service Encounter”

Author (Year)	Definition
Czepiel, Solomon, Surprenant, and Gutman (1985)	“Service encounters are a form of human interaction important not only to their direct participants (clients and providers) and the service organizations that sponsor them, but also to society as a whole” (p. 14).
McCallum and Harrison (1985)	“Service encounters are first and foremost social encounters. As such they are subject to all the structural and dynamic factors that influence social interaction in general” (p. 35).
Shostack (1985)	“A service encounter is a period of time during which a consumer directly interacts with a service” (p. 243).
Solomon, Surprenant, Czepiel, and Gutman (1985)	“For our purposes, <i>service encounter</i> will be used to indicate face-to-face interactions between a buyer and seller in a service setting” (p. 100, emphasis in original).
Surprenant and Solomon (1987)	“The service encounter is the dyadic interaction between a customer and service provider” (p. 87).

p. 243). While the Surprenant and Solomon (1987) definition focuses on personal interactions, the Shostack (1985) definition accounts for the possibility of interactions between customers and the non-human aspects of some services. In line with the Surprenant and Solomon (1987) definition, the current research focuses more on the personal interactions between service employees and customers.

### Service Encounter Research

Primarily during the 1980s, the service encounter became a growing focus in the services marketing literature. One reason was the recognition that personal interactions between customers and service providers are essential to the delivery of most services (Lovelock and Young 1979; Czepiel 1980; Czepiel et al. 1985). Indeed, for many services, not only must both the customer and the service provider be present for the exchange, some services even require that both parties participate in the actual service delivery (cf., Kelley, Donnelly, and Skinner 1990; Mills and Morris 1986). These high levels of personal interaction necessitate a thorough understanding of the dynamics of service encounters.

Another reason for the increased focus on service encounters has been that the growth of the service sector has made these encounters more customary in daily living. Specifically, statistics have shown that service-producing industries account for more than three-quarters of the U.S. GDP and have fueled labor productivity (CIA 2008; Triplett and Bosworth 2004). According to the January 2008 issue of the CIA World Factbook, the service sector accounts for 78.6% of the U.S. GDP. Similar statistics have been reported in the U.K. and other European countries (CIA 2008, Lewis and Entwistle 1990, Winstead 2000). With increased productivity and employment in service industries, the service encounter has become the central work relationship for many employees.

A third reason for the increased interest in service encounter research has been the increased acknowledgement that the encounter carries much weight in determining a consumer's overall service perceptions. Research has posited that because services are by nature inseparable, intangible, heterogeneous, and perishable, it is sometimes difficult for consumers to fully evaluate the service experience (Zeithaml 1981). This is even more so the case with "purer" services such as health care, auto repair, and financial planning where there is often nothing tangible to evaluate and consumers may lack the expertise to properly assess the service (Guiry 1992, Zeithaml 1981). As a result, consumers

frequently make their service evaluations based solely on service interactions. In fact, service encounter outcomes such as perceived service quality, customer satisfaction, and repeat patronage may be determined *exclusively* by the quality of personal encounters (Bitner 1990; Bitner, Booms, and Tetreault 1990; Parasuraman, Zeithaml, and Berry 1985, 1988; Solomon et al. 1985). Because the events occurring during service encounters have great implications for service outcomes, interactions between customers and service providers have become a popular topic in marketing research.

#### *The Service Encounter Dyad*

Both participants in a service encounter are of equal importance as each party's behaviors affect the overall success of the encounter (Klaus 1985). The outcome of the actual interaction between the two parties determines the rewards received and/or costs incurred by each party (Thibaut and Kelley 1959). Based on this reasoning, service encounter research should be approached from both perspectives. As Czepiel (1990, p. 17) states, "to recommend actions that satisfy only one of the parties to an exchange is not only to suboptimize but also likely to be dysfunctional." In fact, past research has found that the components to service encounter quality are different for the client and the contact personnel (e.g., Brown and Schwartz 1989; Chandon, Leo, and Philippe 1997). Thus interaction quality should not be measured from one side only. The current research aims to incorporate the viewpoints of both customers and employees into the overall analysis. In the next sections, service encounter dynamics are discussed from each perspective.

#### *The Customer Perspective*

The customer's perspective of the service encounter is likely to depend on his or her perceptions of participation requirements, prescribed roles, and performance responsibilities. In the past, services research has largely focused on the influence of service provider behaviors on customers rather than the customer's role and responsibility in the service encounter (Namasivayam and Hinkin 2003). However, due to the interactive nature of services, the customer's role performance, functional performance, and social performance should also be treated as causal factors influencing the outcome of the service encounter (Czepiel 1990). In fact, customers themselves largely design service encounters, as they are the ones that actually initiate and direct the interaction (Namasivayam and Hinkin 2003).

Prior to the actual interaction with a service provider, the customer formulates the “service product” through expectations in his or her mind and subsequently directs the service provider in enacting those expectations (Namasivayam and Hinkin 2003). For example, in a restaurant setting, the customer “determines product parameters such as the price point, menu choices, and desired quality of service even before entering the restaurant. Each of these then becomes a manufacturing specification and the desired service product is fully formed with the help of the service worker” (Namasivayam and Hinkin 2003, p. 27). Hence, customers play an important role in the service delivery process, and the lack of attention given to the customer’s role and responsibility leaves gaps in the understanding of the customer’s perspective of the service encounter.

From the customer’s perspective, service encounters provide a means of satisfying his or her needs and/or desires. As initiators of service encounters, customers generally enter the interaction with set goals and usually facing a time constraint (Lewis and Entwistle 1990). Therefore, customers must be familiarized with the service environment, facilities, systems, etc., to ensure an efficient initiation process (Lewis and Entwistle 1990). During encounters, customers prefer a certain degree of control as there is a positive relationship between perceived control and customer satisfaction (Namasivayam and Hinkin 2003). In fact, customers may want complete control as they sometimes feel that the service provider hinders the delivery process and inhibits them from receiving the desired service product (Namasivayam and Hinkin 2003). This is not to say that customers do not enjoy interacting with service workers. However, due to the inconsistency of customer service, in some instances customers may prefer the high level of control offered by self-service or person-machine encounter options.

As the paying party, the customer may often view him or herself as simply a recipient rather than a participant in the service delivery process. It is important that managers understand customer’s perceived roles and communicate role expectations to them so they are adequately prepared upon entering the encounter. For example, when visiting a new doctor, customers are often expected to provide a detailed health history, previous medical records, a full report of any current symptoms and conditions, insurance information, contact information, dates, etc. before being permitted to see a physician. Unprepared customers or those that perceive their roles as non-participatory may not have all of the required information readily available at the time of the encounter. This lack of

preparation is likely to impede the service delivery process and lead to stress and frustration for the customer and others involved. Thus, customer role expectations should be sufficiently conveyed to customers prior to service encounters, and customer perceptions should be fully considered during the development of service strategies.

### *The Employee Perspective*

With respect to service encounters, managers and researchers have fully acknowledged the need to satisfy customers. However, it is probable that satisfying service encounters are more important to employees than customers because while customers spend only a small percentage of their time in encounters, employees spend entire workdays interacting with customers (Czepiel et al. 1985). It is therefore imperative that managers and researchers also examine how the events and dynamics of the service encounter impact employee factors such as motivation, performance, and behavior as well as how employees view their service interaction roles.

Front-line service employees are “marketers” to the degree that they represent the firm and define and promote the product to the customer (Chase and Tansik 1983) and “managers” to the degree that they manage the relationship between the firm and the buyer (Czepiel 1990). Furthermore, often in the minds of consumers, the service provider *is* the service and therefore, the sole basis of the evaluation of service quality (Schneider and Bowen 1985; Shostack 1977). These ideas highlight the importance of service employees to service firms. Although labor may be one of the highest cost elements in service organizations, front-line service workers may also be the biggest assets because they often influence customer attitudes and behaviors and ultimately organizational success (Lewis and Entwistle 1990).

From the employee perspective of the service encounter, service delivery may require “emotional labor” as employees are sometimes required to mask their own feelings and expressions of feeling in order to perform their jobs according to the desires of customers and managers (Hochschild 1983). Emotional labor is “the management of feeling to create a publicly observable facial and bodily display; [it] is sold for a wage and therefore has exchange value” (Hochschild 1983, p. 7). In other words, employees experience a “commercialization of human feeling” as their emotional styles become a part of the service itself (Hochschild 1983). Employees that exhibit positive emotions create value for the firm.

As explained by Chandon et al. (1997), for employees, the service encounter involves a four-step sequence. In step one, employees gather perceptions of what consumers expect from the service and then translate those perceptions into a service proposal in step two. Steps three and four involve the actual delivery and communication of the service to consumers. Throughout the delivery process, service employees take cues from customers to determine appropriate actions and although satisfying customer requirements is a huge component of the service encounter, service employees are also affected by the interaction. Specifically, service encounters impact employees in the areas of job satisfaction, work motivation, and performance (Lewis and Entwistle 1990). Therefore, the employee perspective of the service encounter involves more than just performing tasks that satisfy customers. Service employees also base their service encounter perceptions on the rewards and benefits they receive for themselves.

#### Theoretical Explanation of Service Encounter Research

Service encounters mainly occur in “interdependent” situations (Mohr and Bitner 1991). Interdependence is “the effect interacting persons have on each other’s outcomes in a social relationship” (McCallum and Harrison 1985, p. 35). While not explicitly used in hypothesis testing in the current research, interdependence theory is used here as an underlying principle for explaining service encounter dynamics.

Interdependence theory is a general theory of social relationships that addresses the influence that psychological and situational factors have on each party in a relationship and the kinds and degrees of power the parties have over each other in determining situational outcomes (Kelley and Thibaut 1978). Interdependence involves one’s own actions, the actions of others, and the joint actions of individuals in social situations. This means that a dyadic social interaction is complicated not only by the attitudes and behaviors of each individual in the dyad, but also by each individual’s perceptions of the other person’s attitudes and behaviors as well as the combination of both party’s attitudes and behaviors. These interactions may be further complicated by a struggle for control as each party in the dyad attempts to achieve his or her personal goals. Ultimately, goal achievement depends on the congruency of the behaviors of each party.

Interdependence in service encounters is not always symmetrical. At times, the customer may be more highly dependent on the service provider during the encounter (e.g., health care, auto repair, and financial planning) or less dependent in cases of self-

service or customer expertise. However, due to the inseparable nature of services, interdependence is expected in the majority of service encounters. The level of interdependence between service providers and consumers is determined by how much each party's behaviors influence the other party's outcomes (McCallum and Harrison 1985). During a service encounter, both the customer and provider desire rewarding outcomes, however, having to depend on each other to receive rewards is a cost in of itself. Successful service encounters are those in which both the consumer and provider receive their desired outcomes despite the cost of interdependence.

In the current research, both customer and employee outcomes and their resulting ripple effects are posited to be a direct result of the perceived quality of service interactions. Interdependence between the provider and client highly impacts interaction quality as both the client and provider have interlocking roles to follow throughout the service delivery process and share an understanding of what is supposed to happen to facilitate the exchange. The outcomes of encounters depend on how well each party fulfills his or her roles as well as the social and relational aspects of the interaction. Thus, many aspects of service encounters are interdependently determined and must be managed to achieve preferred outcomes such as satisfaction, loyalty, and financial success. Furthermore, examinations of service encounters should be administered from the perspectives of each interacting party while accounting for any interconnected consequences that may result from interdependency.

#### Profit Linkage Research

Beginning in the 1980s, the field of marketing started shifting away from a focus on transactional exchanges to a focus on examining the effects of long-term buyer-seller relationships (cf., Dwyer, Schurr, and Oh 1987; Morgan and Hunt 1994). This shift sparked new research into concepts like relationship marketing (e.g., Dwyer et al. 1987; Morgan and Hunt 1994; Sheth and Paravatiyar 1995) and customer relationship management (CRM) (e.g., Reinartz and Kumar 2000, 2003; Winer 2001). While relationship marketing "refers to all marketing activities directed toward establishing, developing and maintaining successful relational exchanges," (Morgan and Hunt 1994, p.22) CRM involves the strategic management of ongoing customer relationships. Thus, CRM is one component of the relationship marketing paradigm.

Key to the concepts of relationship marketing and CRM is the notion that customers should be treated as financial assets to the firm (Lewis 2005). Yet, in the past, managers and researchers were not able to fully assess the value of customers due to a lack of information. However, in light of the information revolution, organizations began to collect large databases of records on their customers, enabling managers and researchers to more deeply examine the financial impact of customers. Interestingly, once equipped with this information, managers and researchers started to realize that not all relationship marketing efforts are profitable. That is, not all customers are worth keeping. According to Berger and Nasr (1998, p. 18), “relationship marketing is costly. It might not pay to maintain long-term relationships, at least not all the time and not with all customers.” This line of reasoning led to the idea of assessing the value of individual customer relationships to determine how to allocate marketing efforts and firm resources to customers.

In order to facilitate the valuation of customers, many managers and researchers have adopted a concept called “customer lifetime value” (CLV). CLV represents the net revenues minus costs derived from a lifetime of transactions with a customer (Jain and Singh 2002). It involves assessing the value of a firm’s long-term relationships with its customers. The collection of CLVs within a firm’s portfolio of customers makes up its overall “customer equity” (Rust et al. 2004). Having equity within a firm’s portfolio of customers requires proper management of firm-customer relationships and has been called “customer asset management” (Berger, Bolton, Bowman, Briggs, Kumar, Parasuraman, and Terry 2002).

With the increased interest in relationship marketing and a focus on relationship value management, organizations have sought the development of models and frameworks that help explain the connections between several organizational concepts and financial performance (Payne et al. 2001). In marketing research, these models have been given a variety of labels such as “linkage models,” “performance-based frameworks,” “enterprise performance models” and “marketing performance measurements” (cf., Payne et al. 2001; Clark and Ambler 2001; O’Sullivan and Abela 2007). In these models, a variety of constructs have been “linked” and tested in relation to financial performance. Possibly the most popular example of a linkage model is the service-profit chain (cf., Heskett et al. 1997).

Both customer and employee constructs have been included in profit linkage frameworks. However, in popular frameworks like the service-profit chain, employee constructs are depicted as antecedents to customer constructs which indicates that employees have not been “valuated” in the same manner as customers. The current research seeks to contribute to the profit linkage domain by also examining the financial significance of employees. This research suggests that like customers, employees can be viewed as strategically manageable firm assets that can be incorporated into performance models more directly.

#### Theoretical Explanation of Profit Linkage Research

From a theoretical perspective, profit linkage in firm-customer relationships can be traced to the transaction cost theory of the firm (cf., Coase 1937) and the idea of transaction cost analysis (TCA). While the transaction cost theory of the firm is not directly applied to the hypotheses in the current research, it is used here to provide an underlying rationale for the profit-linkage framework.

TCA implies that a firm is a “governance structure” (Reindfleisch and Heide 1997) in which the transaction costs involved in the economic exchange process should be strategically governed. It entails controlling the relational and opportunity costs of exchange to create greater efficiencies for the firm. According to Reindfleisch and Heide (1997, p. 32), “scholars in marketing and related disciplines have employed TCA to investigate a broad range of exchange-related issues.” The cost of transacting with customers is a big part of the customer valuation process and the underlying principle behind profit linkage frameworks.

In profit linkage research, strategic valuation procedures involve the act of choosing the “right” customers to ensure financial success (e.g., Rust et al. 2004). Effective management of relationships with the right customers requires that transaction costs be kept low. TCA enables a firm to monitor financial performance from a broader standpoint rather than simply relying on overall revenues and costs, and can help managers pinpoint which customers are financial drains and which are assets. Monitoring relationships with customers from a transactional level and incorporating those costs into a system of linkages that influence profit falls in line with the TCA process. Thus, the influence of the philosophies of TCA can be identified in profit linkage procedures.

In addition to TCA, profit linkage research also has foundational roots that correspond to social exchange theory. With roots in economics, psychology, and sociology, social exchange theory proposes that social behavior is the result of an exchange process (Blau 1964). The purpose of this exchange is to maximize benefits and minimize costs. Within the profit linkage and customer valuation paradigms, firms can weigh the potential benefits and risks of social and economic relationships with customers to quantify the values of outcomes. Managers strive to minimize transactional costs and maximize transactional profit and then base relationship decisions on the perceived possible outcomes. If the transaction costs outweigh the rewards, the firm may wish to terminate relationships with customers.

Customer valuation procedures involved in profit linkage strategies consist of identifying and measuring causal relationships that extend from the financial impact of individual customers to overall financial performance. This system of linkages prompts managers to focus on overall profitability rather than on a single goal such as satisfaction. It also narrows attention to specific actions and their payoffs, and encourages managers to strategically link all decisions. Cost-benefit analyses of social exchange relationships encourage managers to choose the best or most profitable options. These options can be readily observed when exchange factors are linked to the bottom line.

#### Profit Linkage and Service Encounters

By linking marketing activities (i.e., service encounter events) and other variables to firm financial performance, the model in the current research falls under the “profit linkage” category. This model finds its origins in similar profit linkage models like the satisfaction-profit chain (Anderson and Mittal 2000), service profit-chain (Heskett et al. 1997) and the return on quality (ROQ) model (Rust et al. 1995). Theoretically, the model embodies a chain of effects flowing from the service encounter to firm financial performance. The system of relationships making up the links in the chain indicates that interactional factors lead to attitudinal and behavioral factors that have financial implications. Thus, service encounter dynamics become an important antecedent to overall firm success.

Similar to “quality” in the ROQ model (Rust et al. 1995), improvements in service encounter effectiveness may be viewed as financially accountable investments. As service encounters are strategically managed to ensure efficiency and satisfaction, firms are likely

to benefit financially. The financial benefits are believed to result from equity produced from customers and employees. Through loyalty and commitment, promotional efforts, transactional profit, and favorable performance during interactions, customers and employees develop into human assets. Strategies aimed at cultivating these assets and eliminating customers and employees that are deemed liabilities enhance the likelihood of financial success. Service encounters provide an opportunity to more comprehensively determine which customers/employees are assets and which are liabilities. Valuation techniques that ignore the precursory impact of service encounter dynamics fail to provide the full picture.

#### Chapter Summary

This chapter has provided a review of the service encounter and profit linkage literatures. This chapter has set the stage for the establishment of a framework that will be used to examine connections between these concepts. In the next chapter, a detailed review of the variables hypothesized to make up the links between service encounters and financial performance is provided. Both customer and employee attitudinal and behavioral outcomes are posited to result from service interactions and ultimately influence firm performance.

## CHAPTER THREE: RESEARCH MODEL AND HYPOTHESES

### Introduction

Considering the goal of making marketing more financially accountable, researchers have progressively developed profit linkage models to connect various marketing variables to firm financial performance. While some of the models have been popularly embraced (e.g., the service-profit-chain by Heskett et al. 1997 and the return on quality framework by Rust et al. 1995), several avenues for expansion exist. For instance, there has been a call for the inclusion of nonfinancial metrics in marketing performance measurements (Clark 1999; Marketing Science Institute 2000). Several nonfinancial marketing concepts have yet to be linked to firm financial performance. For example, thus far, no research has deliberately examined the dynamics of service encounters as a precursor to financial performance. While it is possible that the dynamics of the service encounter are “understood” as underlying principles in past frameworks, there is much to be gathered from these elements provided that they are examined more closely. In addition, many past profit linkage models neglect to fully consider employee factors and the financial value of employees.

The current research is designed to build on previous profit linkage research to provide a more complete examination of the connections between a firm’s frontline service and its bottom line. In particular, this research examines how service encounter dynamics ultimately influence firm financial performance through the impact of customer and employee factors. The current chapter provides the conceptual foundation for an extended approach to financial valuation. The specific purposes of this chapter are: to introduce a conceptual model involving a flow of linkages from service encounter phenomena to firm financial performance, to provide a literature review of the variables that are hypothesized to form these links, and to formalize a set of hypotheses that represent the chain of effects in the model.

The discussion begins with an overview of the full research model. This discussion is followed by a literature review of the constructs in the model along with a specification of the hypotheses that signify the relationships between the variables. Figure

3.1 provides a visual representation of the research model including an indication of the hypothesized relationships.

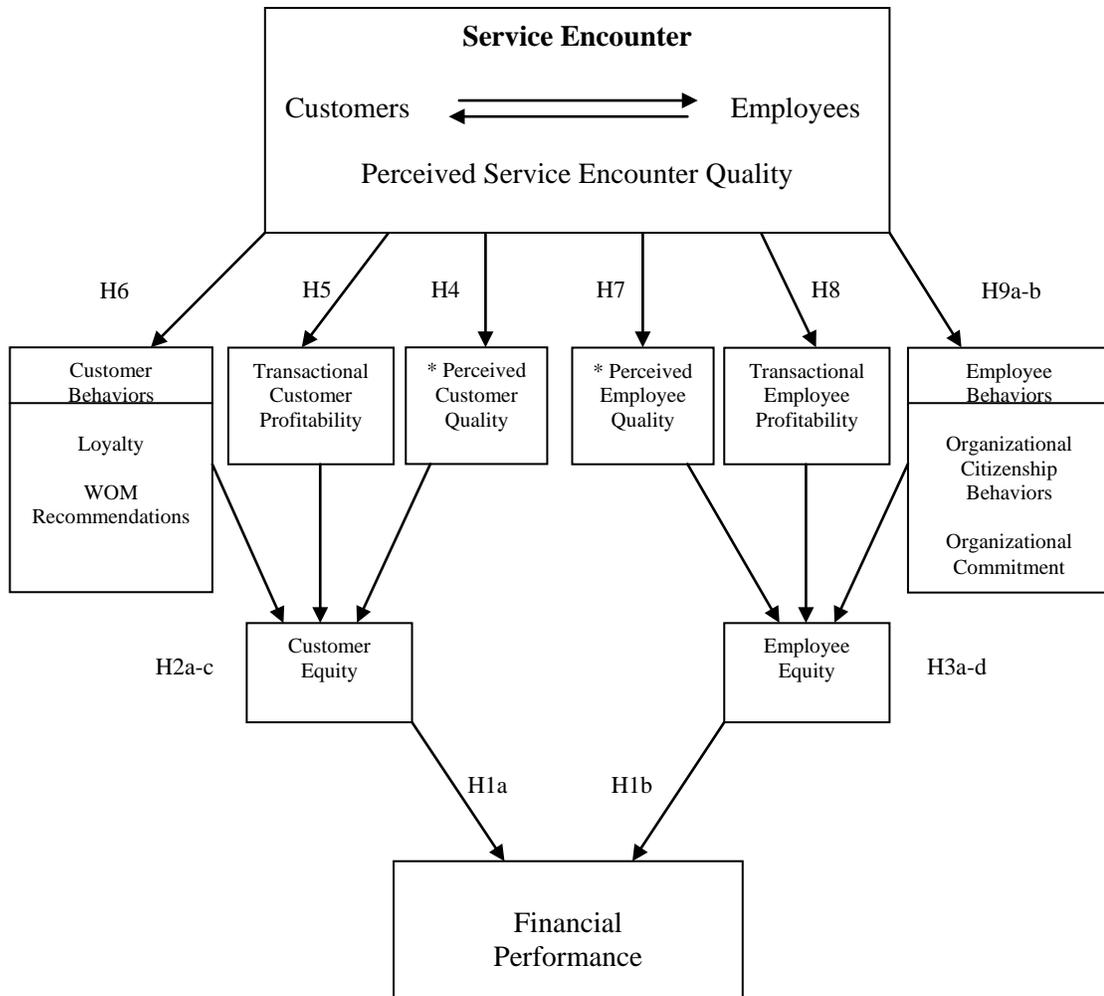
### Model Overview

According to the research model (Figure 3.1), firm financial performance is determined by both customer and employee factors. Ultimately, customer and employee equity determine financial performance (H1a and H1b). The model indicates that a customer's or an employee's equity is influenced by various factors. On the customer side, equity is determined by a customer's transactional profitability, customer behaviors (i.e., loyalty and word-of-mouth recommendations), and employee perceptions of customer quality (H2a-c). On the employee side, the model posits that equity is the result of an employee's transactional profitability, employee behaviors (i.e., organizational commitment and performance of OCBs), and customer perceptions of employee quality (H3a-d). The model further indicates that each party's perceptions are based on how the other party performs during the encounter. On the customer side, perceptions of service encounter quality determine employee perceptions of customer quality, the transaction-based performance of the customer, and the customer's outcome behavior (H4-6). On the employee side, perceptions of service encounter quality determine customer perceptions of employee quality, the transaction-based performance of the employee, and the employee's outcome behavior (H7-H9b). Overall, the current research suggests that it is necessary to examine the events occurring during service encounters as well as service encounter outcomes before establishing customer and employee equity and ultimately firm financial performance.

### Literature Review and Hypotheses

In the sections that follow, a literature review of each of the elements encompassing the chain of effects in the model (Figure 3.1) is presented along with the hypothesized relationships for each link. The review starts with financial performance and ends with the service encounter allowing a foundation to be built for the argument that service encounter success is an essential antecedent to financial success. The review also alternates between customer and employee factors to exhibit the conceptual parallel between the variables on both sides of the model. Each variable is defined and then discussed within the context of service encounters along with its relevance to firm financial performance.

Figure 3.1  
Overall Research Model



\* Due to data limitations, hypotheses involving Perceived Customer Quality and Perceived Employee Quality were not empirically tested in the dissertation.

The discussion begins with the link to financial performance as established by customer and employee equity. Next, the links to customer and employee equity are suggested to result respectively from customer and employee factors. Specifically, while customer equity is proposed to derive from perceived customer quality, transactional customer profitability, and customer behaviors, employee equity is suggested to develop from perceived employee quality, transactional employee profitability, and employee behaviors. Finally, links to the actual service encounter are established with perceived service encounter quality leading to customer and employee factors.

#### The Links to Financial Performance

Marketing researchers have increasingly focused on linking marketing activities to firm financial performance. Researchers have discovered direct links between financial performance and many factors including service quality (e.g., Buzzell and Gale 1987; cf., Zeithaml 2000), customer satisfaction (e.g., Anderson and Sullivan 1993; Rust and Zahorik 1993) customer loyalty (e.g., Heskett, Sasser, and Hart 1990; Reichheld and Sasser 1990), employee job satisfaction (e.g., Abbott 2003; Schneider et al. 2003), and other employee outcomes (e.g., Goldstein 2003). Additionally, many indirect links have also been found. For example, researchers have found an indirect relationship between customer satisfaction and profitability through service quality (e.g., Anderson, Fornell, and Lehmann 1994), between employee job satisfaction and profit through customer satisfaction (e.g., Rucci, Kirn, and Quinn 1998; Terzo 2005), and between employee factors and financial performance through customer factors as in the service profit chain (Heskett, Jones, Loveman, Sasser, and Schlesinger 1994).

Although support has been found for the above-mentioned financial performance relationships, overall findings have been mixed. For instance, Storbacka and Luukinen (1996) found a lack of connection between perceptual and financial variables as evidenced by higher levels of customer satisfaction among unprofitable rather than profitable customers. Additionally, several studies have found both positive and negative evidence regarding the relationship between service quality and profitability (cf., Zeithaml 2000). These mixed findings indicate that additional profit linkage research is needed to achieve the goal of making marketing more financially accountable (cf., Bolton 2004).

A potentially fruitful profit linkage avenue exists in service encounter research. Thus far, the dynamics of the service encounter have not been empirically linked to

overall firm financial performance. In fact, service encounter dynamics have only been examined with customer factors as outcome variables. To establish a link between the service encounter and financial performance, observable aspects of the encounter must be measured. In other words, an indirect link must be established from the encounter to financial performance by way of links with employee and customer factors. The current research endeavors to accomplish this task. Ultimately, firm financial performance is posited to result from customer and employee equity. That is, firms gather much of their financial success from valuable customers and employees.

### Customer Equity

In recent years, marketers have become increasingly interested in valuing customers. However, the concept of calculating a customer's profitability is not new. For instance, research conducted by Sevin (1965), provided a method of computing customer profitability by subtracting functional costs from annual revenues achieved from specific customers. Additionally, Kotler (1974) recognized the necessity of concentrating on key firm accounts by disproportionately allocating firm resources based on long-run customer profitability considerations.

Nevertheless, it has taken a while for many managers and researchers to follow suit and gain an interest in individual customer profitability. Several reasons explain the slow adoption and extension of customer profitability research. Specifically, the need for longitudinal purchase history data, the lack of technological capabilities, and the incomplete understanding of the profit impact of loyalty has discouraged researchers from pursuing the topic (cf., Bell, Deighton, Reinartz, Rust, and Swartz 2002). Instead, managers and researchers have often relied on customer retention rates to signify profitability. However, as point-of-purchase data has become more easily accessible and as technological advances have enabled companies to collect huge databases of customer information, the topic has been taken up with new vigor. Additionally, in recent years, the Marketing Science Institute (MSI) declared that issues such as customer management, the value of loyalty, and the measurement of customer lifetime value are essential research priorities (Bolton 2004). Therefore, marketing researchers have taken on the task of investigating and developing methods that facilitate the profitable management of customer relationships.

Customers have come to be regarded as assets (Gupta and Lehmann 2003) or equity to the firm (Bell et al. 2002; Blattberg and Deighton 1996). Regarding customers as assets or equity indicates that a firm is taking a customer-centric approach in which firms treat relationships with customers as investments (Jain and Singh 2002; Rust et al. 2004). This approach has become so popular that some researchers predict that the customer equity paradigm will become the prevailing paradigm guiding marketing management (Bell et al. 2002). Customer equity has been defined as “the total of the discounted lifetime values summed over all of the firms current and potential customers” (Rust et al. 2004, p. 110). The following formula provides a basic model for calculating customer equity:

$$CE = am - A + a * (m - R/ r) \\ * [r' / (1 - r')] \\ \text{with } r' = r / (1 + d)$$

where  $a$  is the acquisition rate,  $m$  is the transaction margin,  $A$  is the acquisition cost (per customer),  $R$  is the retention cost (per customer, per year),  $r$  is the yearly retention rate, and  $d$  is the yearly discount rate (Berger and Nasr 1998; Blattberg and Deighton 1996). The customer equity appraisal process is conceptually similar to appraising the value of an investment portfolio as firms attempt to maximize equity over their entire customer base (Blattberg and Deighton 1996). Maximum equity is achieved by appropriately balancing customer acquisition and retention efforts (Blattberg and Deighton 1996).

Many companies focus the majority of their resources on attracting new customers. Yet this strategy is not always fruitful in some industries. For example, it takes at least three years for new policyholders at life insurance companies and six or more years for new credit cardholders to become profitable (Heskett et al. 1994). Because it is generally more costly to acquire new customers than to serve current customers (Reichheld 1993), companies must develop strategies to cultivate relationships with the current, loyal customer base. However, because not all current customers are worth keeping (i.e., some are not profitable), and because of high turnover in many industries, acquisition strategies

remain necessary. The key is to determine which customers are profitable and which are not.

The focus on segmenting customers based on their levels of profitability has become both a popular research stream and management practice. For example, Zeithaml, Rust, and Lemon (2001) offer “the customer pyramid” as a method of segmenting customers into profitability tiers. This method addresses the limitations of the popular “80/20 rule” (Kotler 1974). While the 80/20 rule divides customers into two tiers with the top 20% of the customer base as the most profitable and bottom 80% as the least profitable, the customer pyramid segments customers into four tiers (i.e., platinum, gold, iron, and lead) and suggests that two tiers do not adequately account for variation among the bottom 80% of customers (Zeithaml et al. 2001). Additionally, in practice, companies such as FedEx, U.S. West, First Union, Hallmark, GE Capital, Bank of America, and The Limited use profitability segmentation strategies (Zeithaml et al. 2001). Similar to price discrimination, customer profitability segmentation allows firms to offer varying levels of marketing resources to its customers given that it is not always optimal to serve all customers equally (Gupta and Lehmann 2003). However, there are both positives and negatives to customer profitability segmentation practices.

On the positive side, segmentation allows firms to target retention and cross-selling programs to the right customers (Hartfeil 1996), and focus resources on customers with the greatest potential (Connelly and Read 1997). On the negative side, segmentation may result in backlash from customers and regulators (Brady 2000; Gupta and Lehmann 2003). In addition, customers may change segments frequently resulting in inappropriate categorization (Malthouse and Blattberg 2005). Consequentially, while preferential treatment might increase the lifetime value of top customers, it could cause other customers to defect if they discover that they are being treated unfairly (Malthouse and Blattberg 2005). Furthermore, past research has proposed that “of the top 20% [of customers], approximately 55% will be misclassified (and not receive special treatment) [and] of the future bottom 80%, approximately 15% will be misclassified (and receive special treatment” (Malthouse and Blattberg 2005, p. 2). Thus, the potentially harmful effects of misclassification should not be taken lightly. Optimally, firms should develop strategies that *evenly* “match” resources to different customer segments while nurturing those that are less profitable.

According to Blattberg and Deighton (1996, p.137), “managers have begun to think of good marketing as good conversation, as a process of drawing potential customers into progressively more satisfying back-and-forth relationships with the company.” Service encounters present lucrative opportunities for managers to execute this way of thinking. Once customers are acquired, they must be adequately “serviced” to increase the likelihood of retention. Knowing that service failures during encounters often shorten a customer’s life cycle with the firm, managers must ensure that interactions between customers and service employees are as satisfying as possible. As stated by Zeithaml (2000, p. 76), “almost assuredly, service plays a critical role – if not the critical role – in retaining customers”...“providing consistently good service is not as easy to duplicate and therefore is likely to be the cementing force in customer relationships.” As assets, customers and customer relationships must be cultivated during each point of contact with the firm. Service encounters may also offer providers the opportunity to practice “customer alchemy” or the art of transforming less profitable customers into more profitable customers (cf. Zeithaml et al. 2001). Service providers can “train” customers to engage in service activities that are less costly to the firm. They can also teach customers how to engage in proper conduct to enhance the quality of service encounters, extend the life of service relationships, and ultimately increase customer equity.

#### *The Customer Equity-Financial Performance Link*

In summary, customer equity signifies the value of a firm’s customer base. Thus, a firm’s current and potential customers are collectively valued to determine their lifetime value to the firm (Rust et al. 2004). Customer valuation gives firms the ability to allocate resources based on long-run customer profitability considerations. Equitable customers are those that are good investments for the firm. These customers represent significant cash flows and are generally loyal, indicating that they are less costly to serve (Reichheld 1993). Strategically balancing customer acquisition and retention efforts is the key to maintaining positive equity within the customer base (Blattberg and Deighton 1996). In the current model, customer equity is positioned as the sum of the effects of the customer attitudinal and behavioral factors and as an ultimate indicator of firm financial performance. The customer equity link greatly contributes to the chain of effects. Without profitable customers, a firm simply cannot survive. Thus, equitable customers should positively influence a firm’s bottom line.

H1a: Customer equity is positively related to firm financial performance.

### Employee Equity

While marketing researchers have been highly interested in valuing customers and quantifying customer relationships, thus far, employees have not been considered in this manner within profit linkage frameworks. According to Grant and Schlesinger (1995), most organizations neglect to assess the full profit potential of their employees. These authors explain that the profit potential of employees is just as significant as that of customers and firms can advantageously focus human resource investments in a fashion that yields the highest returns. However, the majority of firms have not yet developed human resource systems that are capable of valuing employees and determining their equity to the firm (cf., Grant and Schlesinger 1995). This inability has resulted in unfocused human resource investments that could be strategically expended to guarantee that companies have the “right” employees for the operational processes that lead to profitability.

In the current research, the term “employee equity” is not used in the traditional, managerial sense as in “equity-based compensation for employees” (e.g., Brown 2001) or “equitable treatment within the organization” (e.g., Roberts and Chonko 1999). Instead, for these purposes, “employee equity” is used as a conceptual parallel to “customer equity” to denote the financial value of a firm’s employees. Formally, in this research, employee equity is defined as the degree to which an employee possesses and exhibits the characteristics that are important to a firm’s financial success. The sum of all employees’ individual equities contributes to the firm’s overall workforce or corporate equity.

As with customer equity, loyalty plays a big role in determining an employee’s equity. Because many companies cannot quantify the economics of retaining employees (Reichheld 1993), they often permit high levels of employee turnover, therefore decreasing overall employee equity. Long-term employees are valuable to a firm in that they build relationships with customers that increase customers’ desires to stay loyal, and they are often more efficient than new employees due to training and experience (Reichheld 1993; Reichheld and Teal 1996). Therefore, companies desiring to increase customer loyalty and employee equity must also consider employee loyalty. However,

employee equity is determined by more than just tenure, as employees can create value in a variety of ways.

While each firm requires its own unique employee skill set, equity for most firms will be based on the knowledge, talents, commitment, and creativity of its employees. An employee's equity is also based on his or her level of performance. Defined narrowly, "performance" represents the quantity of output or quality of craftsmanship contributed by an employee (Bateman and Organ 1983). In many organizations, employees are assessed solely based on the outcomes of their performance. However, in determining an employee's equity, a broader performance definition is warranted. A structure that monitors employee activities as well as results provides a more complete measure of employee performance (Hoffman and Ingram 1992). This is particularly true in service organizations where service delivery and encounter success is often more behavioral in scope. Thus, employee equity should be evaluated based on both outcome and behavioral factors.

To facilitate equity assessments (e.g., via employee evaluations), managers should develop baseline performance levels by which to compare each employee's aptitude. Upon identifying the skills, behaviors, and competencies that are most essential to the firm's success, managers can develop strategies to increasingly elevate the baseline (Zingheim 2003). They can also use the baseline for retention, promotion and hiring decisions, as well as for establishing employee performance goals and compensation packages. However, for this process to work, employees must be made to understand how their work fits into the employee-customer-profit model (Rucci et al. 1998). That is, employees need to know what makes them equitable to the firm. Managers must adequately communicate organizational goals and expectations of employees to ensure that employees understand the importance of their own contributions. Additionally, for employees to engage in profitable behaviors, companies must reward them appropriately. In recent years, companies have begun to increasingly utilize variable pay structures to base pay on employee performance (Zingheim 2003). A step further would involve compensation based on employee equity.

Equitable employee behavior can be observed during service encounters. Service employees that consistently deliver high quality customer service are substantially valuable to service firms. As key representatives of the firm, the behaviors of front-line

service employees heavily impact customer perceptions of satisfaction and service quality and ultimately influence the bottom line. The assurance of service encounter success is entrusted to service employees, which makes them essential sources of equity. Equitable service employee behaviors come in a variety of forms. For example, front-line service personnel that demonstrate customer-oriented behaviors are considered valuable to service firms. According to Hoffman and Ingram (1992), customer-orientation is a behavioral performance measure for service employees. An employee's desire to effectively meet customer's needs and ensure the quality of interactions with customers denotes his or her degree of customer-orientation (Brown, Mowen, Donovan and Licata 2002; Donovan, Brown and Mowen 2004). Execution of these behaviors increases an employee's value to an organization. Also, equitable service employees are likely to perform prosocial tasks. Because these behaviors promote the effective functioning of an organization, employees that engage in them contribute to the goals of the organization and ultimately impact financial performance. Service employees that provide high quality customer service, exhibit characteristics of customer-orientation, and participate in prosocial activities are not only valuable to a firm, but may also be an inimitable source of competitive advantage as human resources are difficult to replicate. Thus employee equity can be leveraged to create successful service encounters that eventually result in overall financial success.

#### *The Employee Equity-Financial Performance Link*

In summary, employees are equitable to the degree that they possess and exhibit characteristics that are important to a firm's financial performance. As with customers, the value of employees can be calculated and managed to increase profitability. Employee equity can be used as a tool to aid in human resource investment decisions. In the current model, employee equity is situated as the ultimate predictor of firm performance on the employee side of the model. The aggregate of the effects of employee attitudinal and behavioral factors results in an employee's worth to the firm. As firm assets, equitable employees can be a source of competitive advantage for firms because human resources are hard to imitate. This advantage may potentially lead to increased revenue and market share.

H1b: Employee equity is positively related to firm financial performance.

## Links to Customer Equity

### Perceived Customer Quality

While customers are frequently queried to gather their perceptions of the level of service quality provided by employees, thus far, managers and researchers have neglected to fully consider employees' perceptions of the quality of the customers with which they interact. Even research examining the employee perspective has focused on the employee's perceptions of customer's perceptions rather than their direct perceptions of customer behavior. For example, a study by Bitner, Booms, and Mohr (1994) asked employees to put themselves in the shoes of their customers to describe satisfying (dissatisfying) service encounters. In a sense, these employees were asked to describe what they would think about their own performance if they were their own customers. Hence, this study did not directly address employee's perceptions of customers. Interestingly, however, the results revealed that in most cases, employees blamed external sources for dissatisfactory incidents (Bitner et al. 1994). In fact, while the smallest percentage of dissatisfactory incidents was attributed to negative employee behaviors, the second largest percentage was attributed to problem customers. These findings reveal that employees have strong opinions concerning how customers should behave during service encounters and that employees believe that customers are at least partially responsible for the success of service delivery. It is therefore important for managers and researchers to consider employees' perceptions of the quality and value of customers.

In the current research, "perceived customer quality" is defined as an employee's overall perception of the quality of a customer based on interactions with the customer. Due to their boundary-spanning roles as mediators between organizations and customers, front-line service employees are likely to have different opinions than top management concerning the quality and value of customers. While managers may simply equate quality with the "numbers" or profit contributed by customers, front-line employees may also consider customer personalities and behaviors in quality assessments. Because front-line employees frequently interact with and build relationships with customers (good or bad), they are exposed to the "big picture" and therefore gain a more complete view of customers as individuals. Thus, for employees, perceived customer quality may be viewed as an attitudinal extension of the traditional idea of customer equity.

As managers and researchers have developed techniques for valuating customers, a new trend has emerged in which many companies will either “fire” their “bad” customers or provide varying levels of service quality for customers based on their degrees of profitability. For years airlines have provided pre-boarding privileges to frequent flyers, computer manufacturers have provided more rapid technical assistance to preferred clients, and credit card companies have issued platinum credit cards for more creditworthy customers. However, these forms of preferential treatment have graduated into more blatant attempts to favor “good” customers and dismiss “bad” customers.

Some of the techniques companies are using to vary service quality include varying customer wait times, allowing differing degrees of flexibility, offering special deals and services, using price discrimination, and varying who a customer gets to talk to when they need assistance (cf., Brooks 1999). Interestingly, a “bad” customer for some companies may be considered a “good” customer for others. For instance, in the past, credit card companies have often preferred customers that failed to pay their bills on time and frequently exceeded their credit limits because these customers incurred penalty fees (Snyder 1998). In fact, customers who avoided these mishaps were often hit with other fees simply to make them more profitable (Snyder 1998).

While many managers may believe that customers should be categorized as “good” or “bad” based on their levels of profitability, the appropriateness of this categorization schema is likely to differ in the eyes of service employees. For service employees, a good customer might simply be someone who is polite, friendly, knowledgeable, and allows employees to perform their jobs. On the other hand, a bad customer might be someone who is rude or controlling, or is unaware of or abuses company policies. Because profit data does not tell the whole story concerning the quality of customers, it is best to factor in both financial and nonfinancial attributes when making customer equity calculations.

Over the years, customers have come to expect higher levels of customization, speed, and convenience. Due largely to technological advances, many are also becoming more demanding and expect companies to be more accommodating of their requests. Perhaps, the popular notion that “the customer is always right” has encouraged customers to confidently take advantage of their positions of dominance, which could result in increased complaining, less than polite behavior, and ultimately increased job stress for

front-line service personnel. Thus, nonfinancial factors are likely to play a big role in determining service encounter and financial success.

Traditionally, scholars and practitioners have placed the responsibility for providing satisfactory service solely on the shoulders of firms and their employees when in fact a customer's satisfaction often depends on his or her own behavior (Bateson 2002). Therefore, customers should be held at least partially responsible for service encounter outcomes and should be "managed" and "trained" to enhance their service encounter performance. Perhaps similar techniques through which employees are trained to become more "customer-oriented" (Donavan et al. 2004) can be employed to train customers to become more "service encounter-oriented."

The efficiency of the service delivery process is at least partially driven by customer performance (Bateson 2002). As active participants in service production, customers can either hinder or facilitate successful encounters. Proper management and training of customers decreases the likelihood of service failures. While training enables service providers to communicate their expectations of role performances to customers, managing ensures that customers' performances are satisfactory. The degree of customer participation in service production can range from simple required presence (e.g., customer must be present to receive a haircut but no task performance is required) to self-service or "partial employment". As partial employees, customers are required to perform tasks that are traditionally attributed to regular employees (Bowen and Schneider 1985; Kelley et al. 1990; Lovelock and Young 1979; Mills and Morris 1986). The higher the degree of customer involvement in service delivery, the greater the need for customer management or "consumer socialization". For service organizations, the consumer socialization process involves familiarizing customers with organizational values and performance expectations and equipping them for interactions with employees (Kelley et al. 1990). Through this process, organizations can nurture customers to behave as desired and therefore increase their customer quality and overall value to the firm. As a consequence, increased customer quality will have a positive impact on customer equity.

#### *The Perceived Customer Quality-Customer Equity Link*

To summarize, customer behavior and performance during service encounters can positively or negatively influence the service delivery process and ultimately financial performance. Based on service encounter conduct, some customers may be more or less

valuable than others. Equity calculations that neglect the incorporation of nonfinancial customer factors are likely to result in either over- or underestimated customer equity. The nonfinancial factors involving customer behavior and performance during service interactions are most visible to a firm's front-line service employees. Thus employees may provide vital information for determining customer quality. Positive employee perceptions of customer quality indicate that a customer is likely to be valuable to the firm.

H2a: Perceived customer quality is positively related to customer equity.

### Transactional Customer Profitability

While the current research seeks to extend traditional definitions of customer equity beyond purely financial factors, it is also acknowledged that a customer's financial and transactional profitability is also an important contributor to his or her equity to the firm. That is, the profit gained from transactions with customers leads to customer equity. In the current research, transactional customer profitability is defined as the revenue obtained from customer transactions minus the costs incurred from the exchanges.

Common sense might suggest that for customers to truly be valuable to a firm, they must engage in repeat patronage of that firm over a long period of time. However, it should not be assumed that loyal customers are always more profitable (Dowling and Uncles 1997). In fact, previous research has revealed that high revenues may be more important than loyalty duration as short-life customers may spend more over a short period of time than long-life customers spend over their entire duration with the firm (Reinartz and Kumar 2000). Thus, even short-term, individual transactions should be accounted for in equity calculations. Firms that choose to ignore the profit potential of short-term transactions in favor of long-term relationships (e.g., requiring long-term contracts) may run the risk of losing significant profit to more flexible competitors. However, it still remains that long-term relationships with customers, and thus more transactions over a customer's lifetime, often lead to higher customer profitability.

As described previously, customer equity includes a customer's lifetime value (CLV) to a firm. Individual transactions are significant elements of CLV because the accumulation of these transactions establishes a customer's equity as profit is acquired

through customer loyalty. CLV represents “the net of the revenues obtained from [a] customer over the lifetime of transactions with that customer minus the cost of attracting, selling, and servicing that customer, taking into account the time value of money” (Jain and Singh 2002, p. 37). The duration of a customer’s tenure with a company is not enough to conclude positive lifetime value (Reinartz and Kumar 2000). A customer is only valuable to the extent that he or she has a positive, increasingly profitable relationship with a firm via lower serving costs and a willingness to pay higher prices over time (Reinartz and Kumar 2000). CLV calculations are beneficial because they enable firms to quantify their customers and their customer relationships. They also reveal that customers who may appear to represent insignificant cash flows in the short run may prove to be highly equitable in the long run (Hallowell and Schlesinger 2000). The basic formula for calculating CLV is as follows:

$$CLV = \sum_{i=1}^n \frac{(R_i - C_i)}{(1 + d)^{i-0.5}}$$

where  $i$  = the period of cash flow from the customer transaction;  $R_i$  = revenue from the customer in period  $i$ ;  $C_i$  = total cost of generating revenue  $R_i$  in period  $i$ ;  $n$  = the total number of periods of the projected life of the customer; and  $d$  = the yearly discount rate (Jain and Singh 2002). Customer equity then becomes the total of the CLVs of current and potential customers (Rust et al. 2004). Logically, companies should not spend more than a customer’s CLV to acquire or retain that customer.

Despite the benefits of CLV, the concept is limited by the fact that standard calculations have limited applicability (Jain and Singh 2002) and do not account for customer learning, strategic customer decision making, or chance purchases (Lewis 2005; Malthouse and Blattberg 2005). CLV is further complicated by the uncertainty of whether to treat defected customers as “lost for good” or “always a share” (Dwyer 1997). That is, firms cannot predict with certainty when a customer’s “life” ends and it is therefore not possible to calculate lifetime value with complete accuracy. These limitations have caused many managers to struggle with using CLV and shy away from putting it into practice (Simms 2002). However, as the CLV concept continues to mature in popularity

and progress methodologically, its application may become more commonplace. In the meantime, many firms are still interested in the profitability of their customers and continue to track the revenues and costs that yield from customer transactions.

#### *The Transactional Customer Profitability-Customer Equity Link*

In summary, the profit earned from transactions with customers is a determinant of customer equity. Taking into account revenues earned minus costs incurred and accrued across customer transactions, profitability can be assessed. It is imperative that managers evaluate customer equity with a consideration of the quantitative customer factors that indicate profitability over time. Increased CLV leads to increased customer equity (Rust et al. 2004). Likewise, from a business unit perspective, business units with customers that provide higher profitability will have increasing levels of customer equity.

H2b: Transactional customer profitability is positively related to customer equity.

### Customer Behavioral Outcomes

#### Customer Loyalty

Several researchers have argued that merely satisfying customers does not always suffice (Deming 1986; Jones and Sasser 1995; Stewart 1997; Reichheld and Teal 1996). This reasoning is based on the realization that satisfaction and loyalty do not always vary concomitantly (Stewart 1997). In fact, it is common for even satisfied customers to defect from organizations (Jones and Sasser 1995; Reichheld and Teal 1996). Ignoring this phenomenon is what Reichheld and Teal (1996) refer to as “the satisfaction trap.” They indicate that satisfaction surveys are not as reliable as actual customer behavior and state that “in business after business, our research has shown that 60 to 80 percent of customers who defected had said on a survey just prior to defecting that they were satisfied or very satisfied” (Reichheld and Teal 1996, p. 237). Companies often fall into the satisfaction trap when they forget that satisfaction does not always denote cash flow and therefore measurement of loyalty and retention is a necessity (Reichheld and Teal 1996). Thus, in matters of financial performance, customer loyalty is an essential determinant of equity.

Customer loyalty definitions have been affective, cognitive, behavioral and attitudinal in theoretical founding. While on the affective side, customer loyalty may be defined as “pleasurable fulfillment” (Oliver 1997), on the cognitive side, customer loyalty

may be viewed as “the enduring psychological attachment of a customer to a particular service provider” (Butcher, Sparks, and O’Callaghan 2001, p. 312), or the product or service that comes first to a consumer’s mind when making a purchasing decision (Newman and Werbel 1973). Additionally, while attitudinal definitions are based on a customer’s preferential dispositions that lead to loyalty, behavioral definitions are more outcome-focused and describe customers’ actions that signify loyalty (Bloemer and de Ruyter 1999). To date, researchers have not settled on one, unifying definition of customer loyalty. Perhaps loyalty consists of phases of loyalty development (i.e., cognitive, affective, conative, and behavioral) as suggested by Oliver (1999). The current research takes the position that customer loyalty is a behavioral outcome variable that plays a role in determining a customer’s equity to the firm.

Despite variation in definitions of customer loyalty, researchers concur that loyalty is critical to firm performance because it is a strong predictor of profit (Fornell, Johnson, Anderson, Cha, and Bryant 1996, Heskett et al. 1994, Reichheld and Sasser 1990). According to Reichheld and Sasser (1990, p. 105), “as a customer’s relationship with the company lengthens, profits rise. And not just a little. Companies can boost profits by almost 100% by retaining just 5% more of their customers.” This huge impact of customer retention is the result of the fact that loyal customers generate profits at an increasing rate, pay higher prices than new customers because of reduced price sensitivity, are more cost efficient for firms to serve, and often provide free advertising via positive word-of-mouth (Reichheld and Sasser 1990). Loyal customers produce a degree of profit stability that is not afforded by the intermittent sales from other customers. Additionally, managers and researchers have discovered that retaining current customers is considerably less expensive than attracting and acquiring new customers (Alford and Sherrell 1996; Fornell and Wernerfelt 1987; Reichheld and Sasser 1990). Therefore, managers must strategically attempt to minimize defection rates and provide current customers with adequate reasons to remain loyal.

Customer loyalty is particularly integral to service encounter research because of its relational nature. More so than customer satisfaction, loyalty represents a deeper level of commitment by the customer (Payne and Webber 2006). Interpersonal relationships in services play a significant role in determining service loyalty. As customers and service providers repeatedly interact during the exchange process, relationships are formed.

Having a vested interest in these relationships, customers are generally more loyal to services than they are to tangible products (Bloemer and de Ruyter 1999; Gabbott and Hogg 1994). Additionally, due to high levels of perceived risk in many services (Zeithaml 1981), customers are likely to remain loyal once relationships are established rather than taking the chance of incurring switching costs and/or the potentially negative consequences of risk (Bloemer and de Ruyter 1999).

Past research has shown that service encounter relational variables such as “friendship” have a direct influence on customer loyalty and “social regard” and “social comfort” have indirect influences on loyalty through perceived core service quality and service encounter satisfaction (Butcher et al. 2001). Furthermore, as relationships between customers and providers endure, customers gain a sense of “ownership” over the service and often refer to providers as “my accountant”, “my hairdresser”, or “my mechanic” (Gabbott and Hogg 1994, p. 320). At this degree of loyalty, customers are also likely to be more forgiving of service provider failures by shrugging them off as the provider having “just a bad day” (Gabbott and Hogg 1994, p. 320). Service encounters provide strategic opportunities for firms to increase customer loyalty as employees build long-lasting, engaging relationships with customers.

#### Word of Mouth Recommendations

Interpersonal communication is a frequently used source during external information search (Price and Feick 1984). Consumers often look to other consumers for product information through what is termed “word-of-mouth communications.” Word-of-mouth (WOM) has been defined as “informal, person-to-person communication between a perceived noncommercial communicator and a receiver regarding a brand, a product, an organization, or a service” (Harrison-Walker 2001, p. 63) or “an exchange of thoughts, ideas, or comments between two or more consumers, none of whom is a marketing source” (Swanson and Kelley 2001, p. 195).

WOM is also an “experience delivery mechanism” that allows consumers to vicariously engage in product trial through other consumers’ experiences (Silverman 1997). This indirect product trial conserves consumer resources such as time, money, and effort and alleviates the risks associated with actual product purchase (Silverman 1997). Recent research has indicated that WOM via online reviews has impacted both book sales (Chevalier and Mayzlin 2006) and box office revenue (Liu 2006). WOM also influences

the speed and probability of product adoption (Arndt 1967; Silverman 1997), perceptions of firm image (Clow and Beisel 1995; Murray 1991), and consumer expectations of future service encounters (Bolton and Drew 1991; Clow and Beisel 1995; Murray 1991). Consumers also rely on the WOM process to gain social support for purchases by finding comfort in the fact that other consumers endorse their purchase decisions (Arndt 1967).

Although it has not been proactively managed in marketing practice (Wirtz and Chew 2002), WOM is a powerful force. As a behavioral outcome, consumers like to influence other consumers' decision-making processes through the use of both positive and negative WOM. Researchers have recognized the vast variations of behavioral effects between these two types of communications. Negative WOM has been discovered to be more influential than positive WOM (Wangenheim 2005). Complaining via negative WOM gives consumers a convenient outlet for expressing their dissatisfaction. In fact, while a satisfied customer is likely to tell only three people about their experience, a dissatisfied customer is likely to tell approximately eleven people (Silverman 1997). Despite the huge impact of negative WOM, managers tend to rely solely on registered complaints of dissatisfaction rather than exploring WOM behaviors (Gremler, Gwinner and Brown 2001; Richins 1983). However, because satisfaction is not always followed by positive WOM, the impact of WOM should be given its own consideration.

Due to unique characteristics of services (i.e., intangibility, heterogeneity, inseparability), WOM is more important for services than goods (Harrison-Walker 2001; Wirtz and Chew 2002). These unique characteristics make services more difficult to evaluate prior to purchase (Zeithaml 1981) and therefore more risky for consumer trial (Murray 1991). Professional services as well as others that are high in experience and credence qualities rely heavily on WOM. Providers such as physicians, hair stylists, lawyers and CPAs may rely on WOM to obtain new customers (Brown and Reingen 1987). Likewise, new customers feel more comfortable patronizing professional service providers that others refer them to. The greater the perceived risk associated with these services the more likely consumers are to rely on the advice of experienced acquaintances as a method of risk reduction (Murray 1991). Because services are by nature generally perceived to be more risky than goods, marketers should evaluate and attempt to "harness" the power of WOM (Silverman 1997) prior to the service encounter as well as during post-consumption. This will increase the likelihood that customers will enter the encounter with

appropriate expectations and leave the encounter prepared to positively promote the service organization.

### *The Customer Behavioral Outcomes-Customer Equity Link*

To summarize, the customer equity process involves strategic investments in high-value customers. A customer's value to a firm is largely determined by the behavioral outcomes that he or she exhibits. For instance, loyal customers are a major source of profitability because profits commonly rise with increasing tenure (Reichheld and Sasser 1990). In general, firms desire to build long-term relationships with their customers. Thus, many managers and researchers believe that ultimately, only loyal customers are truly valuable to the firm. Additionally, customers who engage in favorable WOM are valuable because they serve as credible, free advertisements to potential customers. Even when customers themselves choose not to repurchase, their positive WOM communications can compensate for lost revenue through new customer trial. Overall, a customer's outcome behaviors contribute to his or her equity to the firm.

H2c: Customer outcome behaviors (i.e., customer loyalty/WOM) are positively related to customer equity.

### Links to Employee Equity

#### Perceived Employee Quality

Despite a continued growth in the service economy, service quality has been perceived to be declining over time (Brady 2000; Gerstner and Libai 2006; Spencer 2003). According to Lewis and Entwistle (1990, p. 41) "consumers are becoming more discerning in their purchase decisions; their expectations of service quality are increasing; and they are getting more critical of the quality of service they experience." This decreasing quality can most readily be observed within the context of the service encounter, materialized as service performance gaps (Chenet, Tyan, and Money 1999; Parasuraman et al. 1985). The significance of employee performance indicates that employee characteristics such as reliability, accessibility, responsiveness, competence, and credibility, are essential to the achievement of superior service quality. Customers generally look for and expect to find these characteristics in the individuals with whom they must interact to facilitate the exchange. When employees are lacking in these areas,

customer's general attitudes toward the firm are negatively impacted. Service encounters provide opportunities for firms to make good service quality impressions on customers. Furthermore, while service firms have difficulty competing based on tangible factors; service encounters facilitate the creation of a competitive advantage, as superior employee quality can become a core competency.

In the current research, "perceived employee quality" is used as a parallel to perceived customer quality. That is, both customers and employees are assessed based on the quality of their performance during service encounters. Formally, perceived employee quality is defined as the customer's perception of the overall quality of an employee based on interactions with the employee. The degree of perceived employee quality is a determinant of the degree of employee equity. Employees that customers perceive as good quality create value for the firm and are therefore more valuable than employees that perform poorly. For service personnel, the quality of performance is examined based on social factors that are revealed through interactions. Because of intangibility in most services, customers often assess a firm based on the interaction with service personnel and use cues such as the appearance, attitudes, and behaviors of service personnel as proxies for overall firm quality. Since service quality represents an individual's overall attitude toward the service firm (Parasuraman et al. 1988; Zeithaml 1988), and because for many consumers, the service employee *is* the service (Schneider and Bowen 1985; Shostack 1977), perceived employee quality is likely to significantly influence perceptions of overall service quality.

Theoretical rationale for the perceived employee quality construct stems from the "functional quality" aspect of the Gronroos (1984; 1990) service quality model. Functional quality concerns the actual process of service delivery and involves quality evaluations that are based on *how* the service is performed as opposed to a focus on the more technical aspects of the service (Gronroos 1984; 1990). Similarly, the perceived employee quality construct stems from the "SERVPERF" view of service quality, which is a performance-based approach that suggests that service quality should be measured as the customer's attitude toward only the performance aspects of service delivery (Cronin and Taylor 1992). Focusing on the process and performance characteristics of service delivery requires consideration of employees, as employees are responsible for processing and

performing the service. Employees that perform well should be considered highly equitable to the firm.

#### *The Perceived Employee Quality-Employee Equity Link*

To summarize, the customer's perception of employee quality is an important determinant of an employee's worth to the firm. As customers interact with service personnel, they are likely to evaluate the attitudes, behaviors, and performances of the personnel when assessing service quality. To the degree that an employee delivers a good quality performance during service interactions, he or she will be viewed as a high quality employee. High quality employees are valuable to the firm because they effectively deliver good quality service on behalf of the organization and because they play a role in the creation of favorable customer perceptions.

H3a: Perceived employee quality is positively related to employee equity.

#### Transactional Employee Profitability

While the current research highlights the idea that an employee's equity consists of more than just financial, outcome-based measures of performance, it also holds that an employee's transaction-based performance contributes to his or her equity to the firm. In many cases, managers are more interested in financial results than behavior-based outcomes when evaluating employees. For instance, measures such as sales volume, gross margin, net margin, and cost/sales ratio are commonly used to evaluate salespeople (Anderson and Oliver 1987). Although behavior-based approaches provide a more thorough account of employee performance (Hoffman and Ingram 1992), outcome-based systems have the advantages of motivating employees to perform at profitable levels and eliminating the subjectivity that often arises in behavior-based evaluations (Anderson and Oliver 1987). Additionally, outcome-based measures are easily accessible and simple to calculate. On a transactional basis, managers and researchers can monitor each employee's financial results and translate those results into equity ratings. Equity ratings can then be used for human resource matters such as promotion and dismissal decisions.

A major goal in using employee equity appraisals is to ensure that a firm has the proper mix of talents and skills within its employee base. It is imperative that within that mix, there are an adequate number of employees that can help a firm to achieve its

financial goals. Employees that are revenue producers are highly equitable to the firm. Additionally, because outcome-based performance is more visible than behavior-based performance, it is likely that financially profitable employees will be more highly regarded than those that perform well in behavior-based categories.

#### *The Transactional Employee Profitability-Employee Equity Link*

In sum, the outcome-based, financial performance of employees is an important determinant of employee equity. Due to the importance of achieving financial goals, managers often evaluate employee performance through the use of transactional profitability metrics. Employees that prove themselves financially are considered valuable to the firm. Thus, the transactional profitability produced by an employee impacts his or her degree of equity.

H3b: Transactional employee profitability is positively related to employee equity.

### Employee Behavioral Outcomes

#### Organizational Citizenship Behaviors

Sometimes employees engage in “supra-role” behaviors that extend beyond the scope of their job requirements. These deeds are referred to as “citizenship behaviors” (Katz and Kahn 1966). Particularly, within the organizational setting, these deeds are referred to as “organizational citizenship behaviors”. Organizational citizenship behaviors (OCBs) are “individual contributions in the workplace that go beyond role requirements and contractually rewarded job achievements” (Organ and Ryan 1995, p. 775). Examples of OCBs might include helping co-workers to complete tasks, going out of the way to satisfy a customer, promoting one’s employer through positive word-of-mouth, conserving organizational resources, etc. These behaviors are often taken for granted even though they “lubricate the social machinery” of the organization (Bateman and Organ 1983, p. 588).

In general, employee evaluations are not explicitly made based on employee performance of OCBs. Furthermore, even though OCBs indirectly influence managerial perceptions of overall employee performance (Donavan et al. 2004), employees are usually not informed that OCBs will be assessed. Therefore, employees are not always

conscientious of the importance of OCBs to the functioning of organizations. From an employee perspective, OCBs provide a means for reciprocating job satisfaction. On the basis of social exchange theory (Adams 1965; Blau 1964), researchers have reasoned that satisfied employees are likely to reciprocate organizational efforts that benefit them (Bateman and Organ 1983). That is, performing prosocial gestures like OCBs enables employees to show their appreciation or “reciprocate” favorable organizational deeds. On the other hand, dissatisfied employees are likely to be unconcerned with being “good citizens.” OCBs have been found to result from employee attitudinal predictors such as organizational commitment (e.g., Organ and Ryan 1995; Williams and Anderson 1991) and employee job satisfaction (e.g., Bateman and Organ 1983; Netemeyer, Boles, McKee, and McMurrian 1997; Organ and Ryan 1995; Smith, Organ, and Near 1983) and have been found to relate negatively to employee turnover (e.g., Chen, Hui, and Seo 1998; MacKenzie, Podsakoff, and Ahearne 1998).

Within the service context, OCBs are particularly meaningful (Payne and Webber 2006). According to Bowen, Gilliland, and Folger (1999, p. 19), OCBs are “critical in service encounters because no one can specify in advance the full range of things that a service employee might have to do in response to unpredictable customer requests.” Unlike traditional OCBs, service- or customer-oriented OCBs are largely engrained into the jobs of front-line service personnel. In other words, for service workers, OCBs are often “in-role” rather than “extra-role” behaviors. Thus, the performance of OCBs may be *required* for employees that interact with customers (Bettencourt, Gwinner, and Meuter 2001; Payne and Webber 2006). Furthermore, these behaviors are often specified in job descriptions and training manuals for many frontline service employees (Bettencourt and Brown 2003).

Service-oriented OCBs are behaviors carried out by customer contact employees and directed at the customer rather than co-workers or the firm (Bettencourt et al. 2001). These behaviors include employee participation in activities to improve service delivery, actual employee performance directed at customers, and employee loyalty to the firm via positive representation and promotion of the organization (Bettencourt et al. 2001). Due to these boundary-spanning behaviors that are required of service employees, service firms must consider OCBs somewhat differently than other firms. Specifically, service

managers should inform employees of the importance of OCBs and then evaluate and reward them based on OCB enactment.

### Organizational Commitment

Research on organizational commitment has been approached from two perspectives (i.e., behavioral versus attitudinal commitment). While the first perspective conceptualizes commitment in terms of overt indicators (e.g., behaviors that exceed role expectations), the other perspective is based on the overall attitude representing one's strength of involvement and identification with an organization (Williams and Hazer 1986). Formally, organizational commitment has been defined as an individual's attitude toward an organization that consists of (a) a strong belief in, and acceptance of, the organization's goals and values; (b) a willingness to exert considerable effort on behalf of the organization; and (c) a strong desire to maintain membership in the organization (Mowday, Steers, and Porter 1979; Steers 1977). An individual's degree of organizational commitment is likely to be influenced by personal characteristics, work experiences, and job characteristics, and is reflected in his or her job tenure, attendance, and performance (Steers 1977).

Many researchers focus on one aspect of commitment termed "affective organizational commitment." Affective organizational commitment concerns an employee's emotional attachment to an organization (Babakus, Yavas, Karatepe, and Avci 2003; Meyer and Allen 1991). It is not to be confused with job satisfaction as satisfaction is an affective response to certain aspects of the job and commitment is an affective response to the firm as a whole (Chiu, Lin, Tsai, and Hsiao 2005; Williams and Hazer 1986). Furthermore, employee job satisfaction is considered a mediator (e.g., Lok and Crawford 2001) or antecedent of employee organizational commitment (e.g., Brown and Peterson 1993; Russ and McNeilly 1995; Williams and Hazer 1986).

As researchers have become increasingly interested in examining the effects of customer satisfaction and loyalty on firm performance, they have realized the important role that employee factors play in the linkage. For instance, organizational commitment is essential to the linkage because the extent of an employee's organizational commitment determines his or her behaviors (Paulin, Ferguson, and Bergeron 2006). Committed service employees are more likely to engage in positive behaviors than are uncommitted

employees. As a result, these positive behaviors lead to more successful service encounters and increased financial performance.

#### *The Employee Behavioral Outcomes-Employee Equity Link*

To summarize, an employee's outcome behaviors contribute to his or her equity to the firm. For instance, the performance of OCBs indicates that an employee is concerned about the effective functioning of the organization (MacKenzie et al. 1998). This concern translates into behaviors aimed at improving service delivery efficiency and satisfying customers, thus potentially cutting operational costs and increasing revenue. Additionally, employees that are attitudinally and behaviorally committed to an organization are financially valuable. An employee's attachment to the firm and commitment to its goals results in loyalty and a willingness to go the extra mile to ensure firm success. Thus, the expression of loyalty through organizational commitment along with the performance of OCBs increases an employee's overall value to the firm.

H3c: Employee performance of organizational citizenship behaviors is positively related to employee equity.

H3d: Employee organizational commitment is positively related to employee equity.

#### Service Encounter Quality

All parties including managers, service workers, and customers desire good quality service encounters (Czepiel et al. 1985). Moreover, each party has the potential to contribute to perceptions of quality. The quality of the service encounter is "the shared experience of gain by participants and stable pattern of behavior associated with a given type of service encounter" (Klaus 1985, p. 24). Taken as a whole, every element making up the design of a service is important and can influence the quality of the service encounter (Shostack 1985). According to Klaus (1985, p.17) service encounter quality is "a complex service configuration of physical, behavioral, psychological, and other variables that needs to be understood and through which service quality must be managed." Managers desiring to change the level of service quality must do so by

manipulating the elements of the service encounter because only the service encounter provides empirically observable variables (Klaus 1985).

Service encounters have been referred to as “moments of truth” (e.g., Bitner et al. 1994; Jayawardhena et al. 2007). These encounters exemplify the moments when customers and service personnel interact and in doing so develop ensuing perceptions. As outcomes of encounters, perceptions of overall service quality are primarily determined by perceptions of the quality of the encounter itself (Lewis and Entwistle 1990). Thus, it is the encounter that must be managed to ensure that these moments of truth are positively evaluated. Past research indicates that managers have the ability to determine the form of service encounter, which aspects of the service to make visible to the consumer, the timing of service encounters, and the level of human interaction experienced by their customers (Shostack 1985). Strategic approaches to managing these elements can positively impact overall perceptions of service encounter quality.

In the past, managers and researchers have favored the measurement of customer perceptions of service encounter quality while neglecting to examine employee perceptions of encounters. Because service encounters are often dyadic, the quality of interactions is just as important to employees as it is to customers. Thus, both customer and employee perceptions of service encounter quality should be examined. Good quality encounters are those in which both customers and employees realize satisfaction and experience a shared sense of gain (Chandon et al. 1997). To ensure that both parties are satisfied, service encounter quality should be examined in relation to both customer and employee factors. Accordingly, this task is undertaken in the sections that follow beginning with a discussion of the links from service encounter quality to customer factors including perceived customer quality, transactional customer profitability, and customer behavioral outcomes. Afterward, the employee side is discussed with an examination of the links from service encounter quality to employee factors including perceived employee quality, transactional employee profitability, and employee behavioral outcomes.

#### The Links to Customer Factors

##### *The Service Encounter Quality-Perceived Customer Quality Link*

Perceived customer quality is determined by how the employee observes the value of a customer as a result of interactions with the customer. As mentioned previously, the idea of including the interaction-based perspective of the front-line service employee in

the determination of customer quality has been overlooked in past research. Essentially, from the employee perspective, the level of customer quality depends on the behavior and performance of the customer along with the degree to which the customer fulfills his or her prescribed roles.

It has been argued that past research has not adequately addressed the effects of the social performance of customers or their roles within the service encounter (Czepiel 1990; Guiry 1992). Like employees, customers should be managed as human resources and “socialized” into organizations (Bowen 1986; Kelley et al. 1990). The interactive nature of services constitutes management of all parties that are responsible for determining service encounter quality. As “partial employees” within the firm (Mills and Morris 1986), customers often participate in the creation of the service product. The degree of a customer’s participation in service delivery may influence his or her satisfaction (Guiry 1992) and perceived service quality (Kelley et al. 1990). It is therefore imperative that managers and researchers understand the effects of customer participation and effectively manage customers during service encounters. Proper customer management and training is likely to increase employee’s perceptions of customer quality and ultimately improve the value of the customer.

Just as customer’s perceptions of the encounter are largely determined by their perceptions of employee quality (e.g., Brown and Schwartz 1989), employee perceptions of encounters are likely to be determined by the quality of the customer. Employee judgments are largely influenced by customer performances during encounters. Unsatisfactory service encounters may be due to inappropriate customer behaviors – the notion that the customer is not “always right”. If a customer behaves (in) appropriately, the employee is likely to perceive (negative) positive overall service encounter quality. Thus, the quality of the encounter is a determinant of the quality of the customer.

H4: Employee perceptions of service encounter quality are positively related to employee perceptions of customer quality.

#### *The Service Encounter Quality-Transactional Customer Profitability Link*

The dynamics involved in service encounters also affect a customer’s transactional profitability. That is, the way that the customer perceives encounter quality can have an

impact on his or her transactional value to the firm. This is because perceptions of service encounter events play a significant role in determining customer behavioral outcomes including the likelihood of future transactions. Collectively, these factors are associated with the concept of “customer relationship economics” (cf., Storbacka 1994).

Customer relationship economics involves linking perception measures (e.g., service quality, satisfaction, intentions, etc.) to action measures (e.g., purchase loyalty, purchase volume, WOM, and customer relationship profitability) to determine financial implications (Storbacka 1994). The basic premise is that ultimately only actual behaviors impact profit and long term profitability, however, it is also assumed that those behaviors result from customer perceptions of quality and satisfaction (Storbacka 1994). Customers that are continually satisfied may develop ongoing relationships with the service provider which will lead to more economic opportunities. Provided that this process is managed appropriately, these opportunities can be favorable with the benefits of transacting with specific customers outweighing the costs.

Managing the association between the perceptual measures and customer relationship profitability requires first managing the episodes that lead to perceptual conclusions. Thus, perceptions of the quality of the service encounter must be enhanced if the desired outcome is increased customer profitability. Customers are deemed transactionally profitable when their favorable service encounter perceptions increase the likelihood of achieving profit from them over future transactions. Therefore, a customer’s perceived service quality leads to transactional customer profitability.

H5: Perceived service encounter quality is positively related to transactional customer profitability.

#### *The Service Encounter Quality-Customer Outcome Behavior Links*

In past research, some customer behavior measures have been criticized for having an overly outcome-based focus and for overlooking the dynamics of the relational elements that influence these outcomes (Bloemer and de Ruyter 1999; Day 1969). According to Svensson (2006, p. 249), “the outcomes of service encounters depend upon the interactive processes and relationships between providers and receivers.” Thus, it is beneficial to examine the interactions that occur during service encounters as antecedents

to customer outcome behaviors. Indeed, outcomes including customer satisfaction (e.g., Brown, Cowles, and Tuten 1996; Butcher et al. 2001; Jayawardhena et al. 2007; Oliver, Rust, and Varki 1997; Winsted 2000), customer perceptions of service quality (e.g., Brown et al. 1996; Stauss and Mang 1999; Svensson 2006), and customer loyalty (e.g., Bloemer and de Ruyter 1999; Butcher et al. 2001; Jayawardhena et al. 2007; Liljander and Mattsson 2002) have been shown to be impacted by service encounter interactions. Boulding, Kalra, Staelin, and Zeithaml (1993, p. 12) stated that they “strongly believe that service quality positively affects important behavioral outcomes such as loyalty and positive word of mouth.” Similarly, in the current research, customer loyalty and WOM are hypothesized to be influenced by service encounter quality.

Particularly within the service context, the intangible and relational aspects involved in encounters play a major role in building and maintaining customer loyalty. Factors such as emotion, attachment, rapport, social bonds, and other relational elements influence a customer’s desire to continually interact with service providers. For instance, in their study, Bloemer and de Ruyter (1999) found that especially in high-involvement services, customer loyalty is determined by the emotions that a customer experiences during the service delivery process. They concluded that “the most important managerial implication from our study is that when explaining service loyalty, a marketing manager should not only focus on satisfaction. In addition he or she should definitely also take into account the emotions experienced during the service providing” (Bloemer and de Ruyter 1999, p. 326). Likewise, using social exchange theory, Sierra and McQuitty (2005) explain how emotions impact loyalty. They hypothesize that inseparability in service encounters leads to a customer’s sense of shared responsibility in the encounter. This means that the customer feels jointly responsible for the success of the encounter because of the relational aspects of the interaction. That sense of shared responsibility then leads to an impact on the customer’s emotions and, in positive situations, ultimately culminates in increased customer loyalty (Sierra and McQuitty 2005). Thus, the emotions experienced by customers during service encounters create a sense of attachment that influences the likelihood of repatronage and service loyalty.

Like emotions, the rapport and social bonds that are established during service encounters are also said to influence customer loyalty. In a retail context, customer-employee rapport has been defined as “the perceived quality of the relationship, dealing

with the communication between two parties and characterized by a connection or understanding among the participants” (Gremler and Gwinner 2008, p. 309). In service encounters, interaction enjoyment and personal connections influence judgments about the service as a whole (Gremler and Gwinner 2000). Those judgments then determine outcomes such as loyalty. In the same way, other relationship marketing factors like social bonding have also been shown to lead to loyalty (Oliver 1999). Ultimately, these relational elements influence a customer’s perceptions of service encounter quality and can affect his or her desire to remain loyal.

WOM is a powerful form of communication that also has a significant impact within the service context. In fact, according to Meuter, Ostrom, Roundtree and Bitner (2000), even encounters with self-service technologies impact WOM. As consumers experience satisfying encounters with these technologies, their WOM communications are more likely to be positive. Likewise, in other service environments, positive WOM is the result of positive customer-employee interactions. Babin, Lee, Kim, and Griffin (2005) explain that WOM is the result of value perceptions that are derived from feelings of affect during encounters. They state that, “when a service experience is particularly enjoyable and/or beneficial, consumers will be motivated to encourage their friends and family to participate in the behavior” (p. 135). Many researchers agree that satisfaction with the service experience leads to positive WOM communications (e.g., Bitner 1990; Bitner et al. 1990, LaBarbera and Mazursky 1983; Woodside et al. 1989). Perceptions of the quality of service encounters have been shown to influence specific WOM behaviors such as “likelihood to recommend” and actual recommendations including both positive and negative WOM communications (Boulding et al. 1993; Parasuraman et al. 1988; Swan and Oliver 1989).

Another significant influence of WOM lies in its impact on the expectations that consumers bring to service encounters (Bolton and Drew 1991; George and Berry 1981; Gronroos 1990; Murray 1991; Zeithaml et al. 1985; 1993). As one consumer engages in WOM communications, his or her experiences influence the expectations of other consumers. Because expectations are important to overall assessments of satisfaction and service quality, WOM communications that impact those expectations can be extremely influential. One study found that because of the importance of dyadic interactions in service transactions, WOM was a bigger contributor to customer expectations of firm

image than were advertising messages (Clow and Beisel 1995). Thus, proper management of service encounter quality is important to the assurance of positive WOM recommendations. In sum, customer outcome behaviors are determined by the customer's perceptions of service encounter quality.

H6: Perceived service encounter quality is positively related to customer outcome behaviors.

### The Links to Employee Factors

#### *The Service Encounter Quality-Perceived Employee Quality Link*

Service providers and researchers need to understand the factors that customers use to assess encounter performance. Because services are characterized by high levels of experience or credence properties (Darby and Karni 1973), consumers are often forced to rely on other cues to evaluate the service delivery process. Past research has suggested that consumers rely on two bases of evaluation for the service encounter: affective and process-oriented evaluation (Alford and Sherrell 1996). While affective evaluation pertains to a consumer's feelings toward a service provider (i.e., provider affect), process-oriented evaluation pertains to a consumer's perceptions of the service delivery process (Alford and Sherrell 1996). Both evaluations are largely dependent on the events that take place during service encounters. That is, service encounters provide opportunities for customers to develop provider affect and perceptions of service delivery. Of particular interest in the current research, much of a consumer's evaluation of a service is constituted by his or her evaluation of employees (Schneider and Bowen 1985; Shostack 1977). Furthermore, evaluations of employee quality are directly influenced by employee behavior and performance during service encounters. Customers can gather much information about a firm's employees through interactions with them. Thus customer perceptions of encounter quality are likely to influence their perceptions of employee quality.

Properly managing and equipping employees for service encounters is important for ensuring high customer perceptions of both encounter quality and employee quality. To increase the probability of good employee performance, service employees must be managed differently than other types of employees due to the unique characteristics of services (Bowen and Schneider 1985; Hartline and Ferrell 1996). Managing service

employees effectively requires comprehension of the multifaceted behaviors demonstrated by employees during service encounters (Bitner et al. 1990). Due to the labor intensive nature of many services there is a high reliance on people. Unfortunately people's performances are inconsistent and may fluctuate day to day (Kinsley 1979). However, employees are not always the cause of fluctuations in the quality of service delivery. Sometimes poor service is the result of the poor design of the service process itself (Lewis and Entwistle 1990). Thus, employees should not be held responsible for factors out of their control and should not be considered the only source of service delivery failures. Service work environments and operational strategies must be designed with employees in mind. Furthermore, employees should not only be fully equipped to perform during the service encounter, they must also be empowered to respond to customer needs (Bowen and Lawler 1992). Implementing effective strategies for employee management and development will improve their transactional profitability.

The dynamics of service encounters are linked to the ensuing consumer perceptions of quality (cf., Klaus 1985). The consumer's experience within the service process facilitates his or her assessment of service quality (Parasuraman et al. 1985; 1988). The attributes, processes, and relational aspects comprising service encounters act as cues that consumers use to form quality expectations and evaluations. Because customers often view the interaction with service employees as the actual service, their perceptions of the quality of customer service will be linked to their perceptions of the quality of the service interaction. That is, customer perceptions of the encounter will impact their perceptions of employees.

H7: Customer perceptions of service encounter quality are positively related to customer perceptions of employee quality.

#### *The Service Encounter Quality-Transactional Employee Profitability Link*

Service encounter events also influence an employee's transactional profitability. Employee perceptions of the quality of their encounters with customers may carry benefits and/or costs that impact the bottom line. Employees are more likely to operate effectively and efficiently when interacting with customers that contribute to positive service encounters. A customer's behavioral performances during interactions with the service

provider carry a significant weight in determining employee perceptions of service encounter quality. Bad customer behavior or inadequate performance can be costly to a firm and result in financial loss. For example, a customer who behaves unpleasantly in an encounter can negatively affect the service experiences of employees. As a result, unhappy employees might defect from the service organization or simply “withdraw” from performing well, which may severely impact the bottom line.

Negative service encounter experiences are likely to detract from an employee’s overall motivation to engage in activities that positively influence the bottom line. If employees are unsatisfied with their jobs due to consistently bad experiences with customers, they may feel that their jobs are simply not worth doing well. On the other hand, pleasant service encounters might inspire employees to not only perform their prescribed tasks well, but also may induce them to engage in more prosocial behaviors and other activities that lead to financial success. Thus, employees that perceive positive service encounter quality have an increased probability of supplying transactional profit for the firm.

H8: Perceived service encounter quality is positively related to transactional employee profitability.

#### *The Service Encounter Quality-Employee Outcome Behavior Links*

Past research has examined numerous antecedents to OCBs and organizational commitment. However, thus far, researchers have not directly focused on the relationship between employee perceptions of customer behavior and performance during service encounters and employee outcome behaviors. In fact, most of the previously examined antecedents of OCBs and organizational commitment have been employee personal characteristics, job characteristics, role states, and organizational characteristics (cf., Mathieu and Zajac 1990; Organ and Ryan 1995; Smith et al. 1983). Interaction characteristics have been largely overlooked in this line of research. As employees interact with customers on the frontline, they are often able to discern how customers perceive encounters and then make adjustments based on customer behavior (Bitner et al. 1994). Considering this fact, it seems reasonable to conclude that service encounters often trigger response behaviors in employees. Therefore, it is expected that positive service

encounters will increase the likelihood of an employee's performance of OCBs as well as his or her affective commitment to the organization.

One way that service employees discern customer perceptions of encounters is through their ability to empathize with customers (Bowen and Schneider 1985). Empathy involves providing customers with caring, individualized attention (Parasuraman et al. 1988) and signifies a person's ability to identify with and understand the feelings of others. Researchers have reasoned that empathy is a principal characteristic for boundary-spanning employees to possess because it enables employees to perceive how customers are experiencing the service encounter (Bowen and Schneider 1985). Interestingly, past research has revealed an empirical link between empathy and helping behaviors (cf., Barnett, Howard, King and Dino 1981). Empathetic employees may be driven out of compassion to go the extra mile to satisfy customers (Bettencourt et al. 2001). Thus empathy experienced by employees during service encounters may compel them to engage in OCBs.

Employee job satisfaction is another factor that impacts employee performance of OCBs (e.g., Bateman and Organ 1983; Williams and Anderson 1991). As stated by Payne and Webber (2006, p. 368):

“First, according to social exchange theory (Adams 1965; Blau 1964), satisfied and committed employees are more inclined to reciprocate behaviors and support to those from whom they benefit. Second, prosocial behaviors are most likely to occur when the employee is experiencing positive affect induced by a good mood (Gardner 1985; George 1991), and job satisfaction is assumed to indicate a positive mood at work (Smith et al. 1983).”

It is likely that a portion of an employee's job satisfaction is determined by interactions with customers. Researchers have stressed the importance of satisfying service encounters for employees (Czepiel et al. 1985). If interactions with customers generate positive affect, good mood, and increased job satisfaction, prosocial behaviors are likely to follow. According to “the norm of reciprocity” (Gouldner 1960), individuals tend to respond positively to favorable treatment received. Thus, favorable perceptions of customer performance during encounters should motivate employees to perform OCBs.

The quality of service encounters also impacts an employee's commitment to the organization. Organizational commitment is important to service firms because service employees' attitudes toward the organization, support of its goals, and feelings of loyalty to the firm affect how employees perform during encounters with customers. Similar to OCBs, organizational commitment is significantly impacted by job satisfaction (Mowday et al. 1982; Williams and Hazer 1986). Employees that are satisfied with their jobs are generally more committed to their organizations and as a result are likely to perform better.

Research indicates that employees are motivated by characteristics of their jobs and work environments (Eby, Freeman, Lush, and Lance 1999). For instance, if employees find their work to be "meaningful," they will be intrinsically motivated to commit to their organizations (Eby et al. 1999). Meaningful jobs include those that provide opportunities for employees to use a variety of skills (skill variety), have an impact on others' lives (task significance), and require the completion of a 'whole' or identifiable product (task identity) (Eby et al. 1999). Jobs that allow employees to "make a difference" result in higher commitment. For front-line service personnel, everyday interactions with customers present such opportunities.

Along the same lines, perceived employee empowerment is another factor that influences organizational commitment. Empowerment is a practice by which employees become more incorporated into an organization through increased involvement in work-related matters (Conger and Kanungo 1988; Thomas and Velthouse 1990). Perceptions of empowerment provide intrinsic motivations that lead employees to feel more affectively committed to the organization (Eby et al. 1999; Thomas and Velthouse 1990). Employees desire to be adequately equipped to serve customers. In fact, one facet of job satisfaction entails whether or not employees perceive organizations as helping them to serve customers (Paulin et al. 2006). This support is particularly important to front-line service personnel. Service encounters in which employees feel empowered to make decisions and to perform tasks that they deem appropriate are likely to be more enjoyable and of more quality from the employee's perspective. Consequently, good encounters will lead to higher levels of affective commitment. Thus, it is hypothesized that organizational commitment may sometimes be a direct result of how the employee perceives the service

encounter. In sum, an employee's perceptions of service encounter quality will determine both his or her performance of OCBs and his or her commitment to the organizational.

H9a: Perceived service encounter quality is positively related to employee performance of organizational citizenship behaviors.

H9b: Perceived service encounter quality is positively related to employee organizational commitment.

### Chapter Summary

This chapter has included the introduction of a conceptual model that links service to the bottom line. This model is designed to expand on previous profit linkage frameworks to include service encounter dynamics in determinations of overall firm financial performance. Incorporating both the customer and employee perspectives and presenting the factors that influence both parties contributes to a more comprehensive consideration of the elements needed to achieve financial success. This chapter has provided a detailed literature review to establish the foundation of a system of linkages between the service encounter and firm performance. Based on the relevant literature, this chapter has also provided a set of hypotheses representing the relationships depicted in the model in Figure 3.1. In the chapter that follows, the methodological and statistical procedures used to test these hypotheses are discussed.

## CHAPTER FOUR: METHODOLOGY

### Introduction

In this chapter, methods are outlined for the investigation of two portions (i.e., the customer side and the employee side) of the conceptual model presented in Chapter Three. Specifically, this chapter covers four main areas including the research setting and design, variable measurement, measurement assessment, and analytical procedures. First, an overview of the overall research methods is provided. Then, within the contexts of two studies, the research settings, research designs, data collection procedures, and operational definitions of variables are discussed. Finally, the overall methods used to assess the reliability and validity of the survey measures are described followed by a discussion of the analytical procedures.

### Overview

To further examine the hypotheses presented in Chapter Three, the overall research model (Figure 3.1) was dissected and then examined within two independent studies and investigated in two distinct settings. That is, a specific portion of the model was assessed in each study. Due to the complexity of the overall model, an empirical investigation within a single analysis would involve procedures that are beyond the scope of this dissertation. Nevertheless, examining the research model in sections permits a more in-depth evaluation of each side of the model (i.e., the customer side and the employee side) and provides a more feasible process for investigating the particular variables of interest.

From a design standpoint, the current research utilizes a combination of data collection techniques and research methodologies. Both Studies 1 and 2 combine survey methods with evaluations of firm financial data. More specifically, in Study 1, the hypotheses on the customer side of the model (H1a, H2b-c, H5, and H6) were tested. Through the use of internal data provided by a financial institution, Study 1 combined firm financial data with in-house customer surveys to examine the customer variables. In Study 2, the hypotheses on the employee side of the model (H1b, H3b-d, H8, and H9a-b) were examined using employees of a computer services firm. Data was collected in the

form of newly developed employee surveys and combined with firm financial data to test the employee variables.

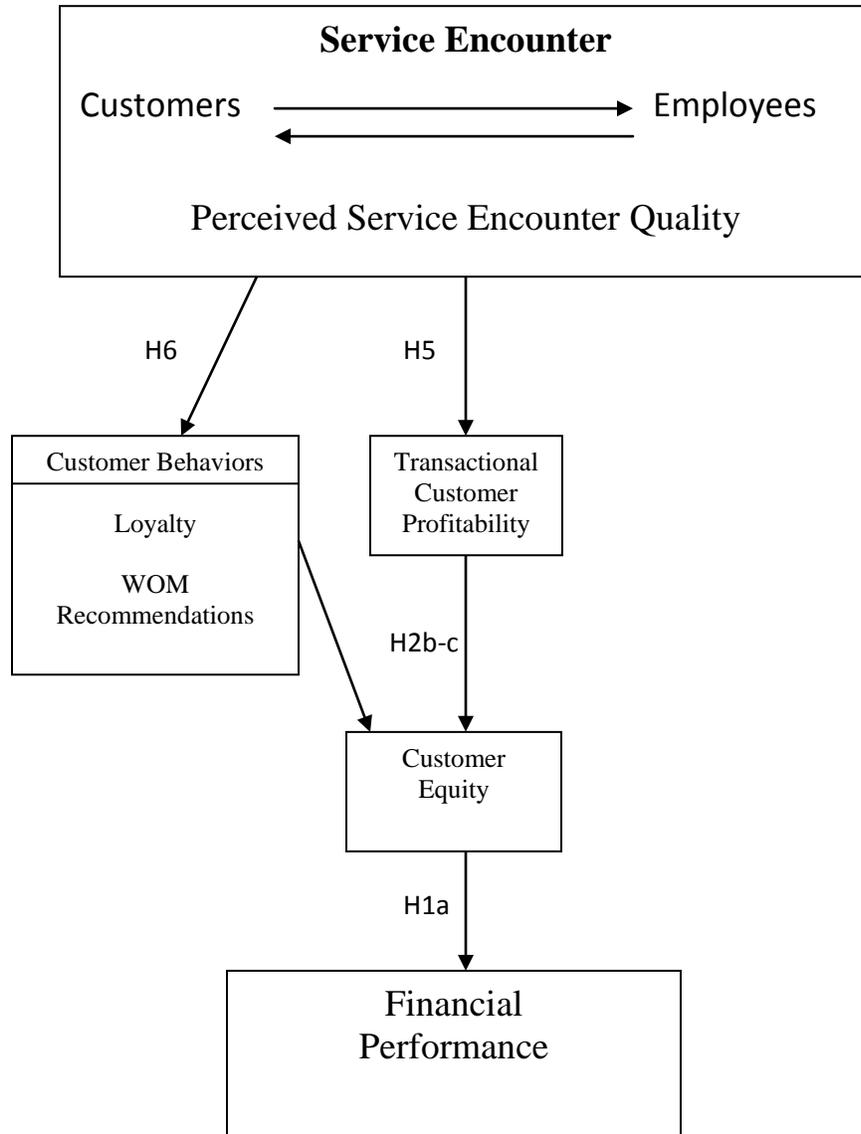
### Study 1: Research Setting and Design

The first study investigated the chain of effects from the service encounter to financial performance on the customer side of the research model (see Figure 4.1). It was hypothesized that customer equity impacts a firm's overall financial performance (H1a). Furthermore, customer equity was proposed to be determined by a customer's transaction-based profitability, coupled with his or her outcome behaviors (i.e., loyalty and WOM recommendations) (H2b-c). It was also hypothesized that the events occurring during service encounters impact a customer's transactional profitability (H5). That is, an employee's behavior and performance during service encounters was a suggested determinant of the revenues and/or costs that the firm acquires from its customers. Additionally, it was posited that the behavior and performance of employees during service encounters will impact a customer's outcome behaviors (H6).

To test these hypotheses, Study 1 took place within the financial services sector. The financial services sector is comprised of service firms such as retail banks, private banks, investment banks, insurance companies, real estate firms, credit card companies, consumer finance companies, and stock brokerage firms. In terms of earnings, financial services make up the largest industry in the world ("The Mistakes," 2004). Financial services present a viable industry in which to examine the current research because service encounters are commonly required to facilitate the exchange of many financial products. For example, retail banking often involves interactions between customers and bank personnel such as tellers and loan officers for the delivery of banking services. Additionally, most financial service firms collect financial data and track the financial activities of their customers. In fact, financial service organizations were among the first to more fully consider concepts like customer profitability (Selden and Colvin 2003).

Study 1 focused on the retail banking industry for the empirical analysis. More specifically, this study examined customer information gathered from a large U.S. regional banking corporation headquartered in the Midwest. This information consisted of data collected through the bank's customer experience surveys and branch level financial

Figure 4.1  
Study 1 Model



data. Longitudinal data from a sample of bank branches in the Southeast was used for this analysis.

### Study 1: Research Variables

In this section, operational definitions are presented for the measures that were used to assess the research model in Figure 4.1. Table 4.1 provides a summary of the measurement specifications for the research variables included in Study 1.

#### *Financial Performance*

In this study, financial performance data was obtained directly from the bank. Considering the banking context, financial performance was measured using branch-level profit data. Furthermore, because Study 1 focused on the customer side of the research model, financial performance was based on customer-driven financial factors. Specifically, each branch was assessed based on its core deposits and contribution margins. Core deposits consist of the overall deposit balance for all households assigned to a branch. This includes all non-loan accounts. The contribution margin signifies the overall profitability of the branch by accounting for total revenues and costs. It is the net income minus chargeoffs and allocations. These financial elements are each driven by customer purchases of as well as utilization of banking products and services. Customers who contribute most to these metrics are likely to be deemed the most profitable. Each of these metrics was used to assess branch-level financial performance.

#### *Customer Equity*

Customer equity is the sum of the lifetime values of a firm's portfolio of customers (Blattberg and Deighton 1996). It involves balancing customer acquisition and retention costs. According to Blattberg and Deighton (1996) measurement of customer equity involves measuring customers' expected contributions toward offsetting the company's fixed costs. In the current study, customer equity is operationalized as the value of the firm's customer base (cf., Wiesel, Skiera and Villanueva 2008) which was measured at the branch level. For the bank branches in this study, the allocation of corporate marketing dollars is determined by how efficient each branch is at using company resources. Becoming an efficient branch requires managers to adequately control both acquisition and retention expenses and essentially provide a return on the marketing investments that are provided by corporate. In the current study, acquisition and retention rates were used

TABLE 4.1

## Measurement of Research Variables (Study 1)

Research Variable	Hypotheses	Primary Source(s)	Supporting Literature	Level of Analysis	Respondent
Financial Performance	H1a	Firm Financial Data	N/A	Branch	N/A
Customer Equity	H1a, H2b-c	Firm Financial Data	Berger and Nasr (1998); Blattberg and Deighton (1996)	Branch	N/A
Transactional Customer Profitability	H2b, H5	Firm Financial Data	Jain and Singh (2002); Reinartz and Kumar (2000)	Branch	N/A
Customer Behavioral Outcomes: Loyalty and WOM	H2c, H6	Customer Experience Survey	Gremler and Brown (1996); Oliver (1997; 1999); Harrison-Walker 2001	Branch	Customer
Perceived Service Encounter Quality: Customer	H5, H6	Customer Experience Survey	Jayawardhena et al. (2007)	Branch	Customer

to signify which branches have most efficiently balanced their portfolios of customers. The following formulas were used to calculate acquisition and retention:

$$\text{Acquisition} = \frac{\text{New Households}}{\text{Current Households}}$$

$$\text{Retention} = \frac{\text{Current Households} - \text{Lost Households}}{\text{Current Households}}$$

#### *Transactional Customer Profitability*

In the current research, transactional customer profitability is defined as the revenue obtained from customer transactions minus the costs incurred from the exchanges. For many financial institutions, customer profitability is measured over some time period such as a three-month and twelve-month rolling average basis or based on CLV calculations (Hartfeil 1996). Financial organizations like banks often calculate customer profitability at the account level (based on individual customer accounts) and then aggregate it to the customer level (which includes all accounts owned by each customer) (Hartfeil 1996). To date, the financial organization used in Study 1 has not instituted CLV practices. However, net income is the basis of CLV calculations (Jain and Singh 2002). Therefore, in this study, transactional customer profitability was operationalized using metrics that are determined by revenues and costs. Specifically, transactional customer profitability was determined by branch-level net income and efficiency ratio. While net income equals revenue minus cost, efficiency ratio is the cost per revenue percentage and represents each branch's expected contribution toward offsetting fixed costs.

#### *Customer Behavioral Outcomes*

In Study 1, customer behavioral outcomes (i.e., loyalty and WOM) are examined as consequences of service encounters. The bank used in this study operationalizes these outcomes using a loyalty index along with a measure of customer satisfaction. Loyalty has been defined in multiple ways in past research. In general, customer loyalty concerns a customer's intention to stay with, and level of commitment to, an organization (Payne and Weber 2006). WOM involves the exchange of communications between two or more consumers (Swanson and Kelley 2001). The bank's loyalty index consists of a "likelihood

to continue business” item and a “likelihood to recommend” item that are combined and measured on a 5-point Likert scale ranging from “Strongly Agree” to “Strongly Disagree”. In addition, the bank uses a 2-item satisfaction measure that examines a customer’s “overall satisfaction” with the bank along with “most recent visit satisfaction” both of which are measure on 5-point Likert scales ranging from “Strongly Agree” to “Strongly Disagree”.

#### *Perceived Service Encounter Quality*

Service encounter quality is “a complex service configuration of physical, behavioral, psychological, and other variables that needs to be understood and through which service quality must be managed” (Klaus 1985, p. 17). In Study 1, perceived service encounter quality was examined using items from the bank’s customer experience survey. The items for the measure are comparable to items from past research. For example Jayawardhena et al. (2007) presented one of the first measures of service encounter quality. Their measure was developed within the business-to-business context, but is also applicable to business-to-consumer situations. In general, their measure uses 7-point Likert scales to examine four dimensions of perceived service encounter quality. The four dimensions include professionalism, civility, friendliness, and competence. On scales ranging from “Strongly Agree” to “Strongly Disagree”, respondents were asked the degree to which they agree/disagree that during the service encounter, the service provider exhibited professionalism (not pushy or condescending), civility (coherent in communication and courteous), friendliness (show familiarity during encounter and build friendly relationship), and competence (informative and qualified to conduct required service).

Items that reflect the dimensions developed by Jayawardhena et al. (2007) were selected from the bank’s customer experience survey and used for the current analysis. Specifically, the customer experience survey includes a four item scale measuring responses to the following statements: the employee was friendly, the employee was easy to do business with, the employee gave individualized attention, and the employee was knowledgeable about the bank’s products and services. These items were assessed on 5-point Likert scales ranging from “Strongly Agree” to “Strongly Disagree.”

### Study 2: Research Setting and Design

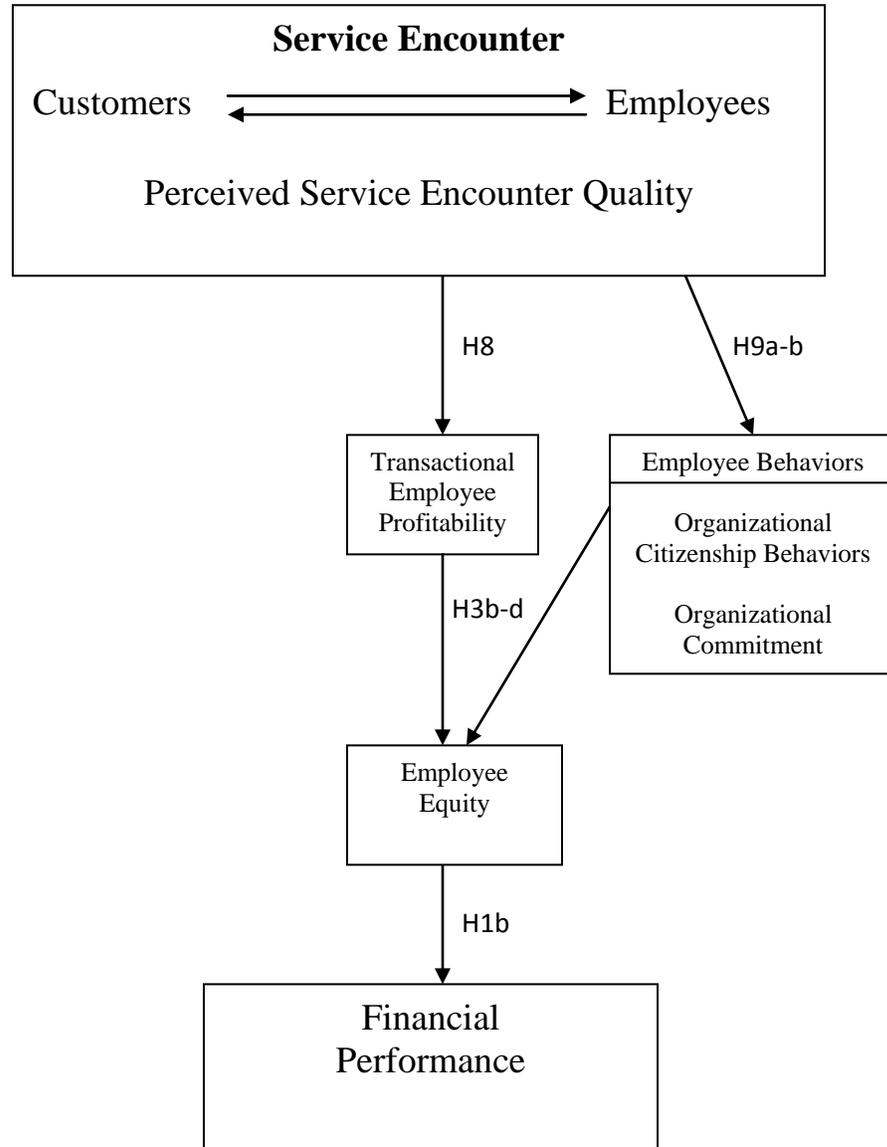
The second study investigated the chain of effects from the service encounter to financial performance on the employee side of the research model (see Figure 4.2). It was hypothesized that employee equity is a determinant of firm financial performance (H1b). In addition, an employee's transaction-based profitability, along with his or her outcome behaviors (i.e., OCBs and organizational commitment) were proposed to determine his or her employee equity (H3b-d). It was also hypothesized that the events occurring during service encounters impact an employee's transactional profitability (H8). That is, an employee's behavior and performance during service encounters was suggested as a determinant of the revenues and/or costs that the firm acquires from him or her. Furthermore, it was posited that the behavior and performance of customers during service encounters will impact employee's outcome behaviors (H9a-b).

To test these hypotheses, Study 2 involves an assessment of the service personnel of a computer services firm. The firm is a leading business process outsourcing (BPO) and information technology (IT) provider headquartered in the Southwest United States. It is a Fortune 500 company of 62,000 people supporting commercial and government clients worldwide. The firm's clients hail from a variety of industries including communications, education, energy, financial services, government, healthcare, insurance, manufacturing, retail, travel and transportation. Each client has a strategic business unit (SBU) that is designated to support its work. In the current study, customer service representatives (CSRs) from five call center SBUs were the focus of the analysis.

Each CSR participated in an online employee survey. The survey measured employee perceptions of service encounter quality, organizational commitment, OCBs, and employee equity. Along with the employee surveys, financial performance records for each CSR were used to measure transactional employee profitability and over financial performance.

Figure 4.2

Study 2 Model



## Study 2: Research Variables

In this section, operational definitions are presented for the measures that were used to assess the research model in Figure 4.2. Table 4.2 provides summaries of the measurement specifications for the research variables included in Study 2.

### *Financial Performance*

In Study 2, the employee-level financial performance of the computer services firm was examined using each CSR's average call handle time. Average handle time (AHT) is the amount of time a CSR spends on each call considering the number of calls he or she completes. Managers establish the acceptable time parameters for each calling task and then determine which calls meet the requirements. The longer the AHTs, the more money the firm in the study must charge its clients, which runs the risk of customer dissatisfaction. If the AHTs get too high, the clients will switch to another vendor. Thus, AHTs are the most financially relevant measure of individual employee performance for the computer services firm. Therefore, in the current study, AHT was used to indicate overall employee-level financial performance.

### *Employee Equity*

An employee's equity to the firm is determined by the degree to which he or she possesses and exhibits the characteristics that are necessary for firm financial success. Thus, an employee's equity depends on his or her job performance. Job performance includes both the quantity of output produced by the employee as well as the quality of his or her work (Bateman and Organ 1983). As front-line service employees, the CSRs in the current study are often subjected to performance evaluations. While the actual evaluations could not be obtained for this study, performance was still evaluated and used to represent employee equity. Specifically, CSRs participating in the study were asked to self-report their performance ratings by indicating the extent to which they agreed or disagreed with statements from the front-line service employee job performance scale developed by Elmadag, Ellinger, and Franke (2008). Their scale is an adapted version of the Babin and Boles (1996) self-report job performance scale. The employees' self-ratings were reported on 7-point Likert scales ranging from "Strongly Disagree" (1) to "Strongly Agree" (7).

Table 4.2

## Measurement of Research Variables (Study 2)

Research Variable	Hypotheses	Primary Source(s)	Supporting Literature	Level of Analysis	Respondent
Financial Performance	H1b	Firm Financial Data	N/A	Individual Employee	N/A
Employee Equity	H1b, H3b-d	Elmadag et al. (2008)	Babin & Boles (1996); Grant & Schlesinger (1995)	Individual Employee	Employee
Transactional Employee Profitability	H3b, H8	Firm Financial Data	Grant & Schlesinger (1995)	Individual Employee	N/A
Employee Behavioral Outcomes: OCBs	H3c, H9a	Smith et al. (1983)	MacKenzie et al. (1993); Smith et al. (1983)	Individual Employee	Employee
Employee Behavioral Outcomes: Organizational Commitment	H3d, H9b	Mowday et al. (1979)	Hunt & Morgan (1994); Porter et al. (1974)	Individual Employee	Employee
Perceived Service Encounter Quality: Employee	H8, H9a-b	Kelley et al. (1990)	Jayawardhena et al. (2007); Solomon et al. (1985)	Individual Employee	Employee

Highly rated employees were proposed to be more equitable to the firm because their mastery of the activities and tasks required for their jobs has financial implications.

#### *Transactional Employee Profitability*

An employee's transactional profitability is based on his or her outcome-based performance. For example, metrics such as sales volume, gross margin, net margin, and cost/sales ratio are often used to measure salesperson performance (Anderson and Oliver 1987). Within the call center context, customer service representatives (CSRs), or "transaction processors" are evaluated and compensated using an activity-based costing (ABC) method (cf., Cooper and Kaplan 1988). ABC enables the computer services firm to control the efficiency of transactional, activity-oriented tasks that affect the bottom line. For CSRs, transactions consist of activities that are necessary for the completion of telephone calls. Evaluation and compensation is driven by both the number of transactions an employee completes as well as the quality of these transactions.

In the current study, transactional employee profitability was determined based on the quality of the employee's performance during transactions. Managers expect each call to adhere to set quality standards. For the call center in Study 2, quality assurance standards include accuracy of information, tone and speech pattern of the call agent, and overall handling of the customer. Calls that are higher in quality are suggested to increase an employee's transactional profitability. Quality assurance ratings for each CSR were provided by managers and were used to represent transactional employee profitability.

#### *Employee Behavioral Outcomes*

OCBs have been operationalized in a variety of forms including altruism, courtesy, sportsmanship, civic virtue, and conscientiousness (MacKenzie, Podsakoff, and Fetter 1993). However, many researchers measure OCBs as two factors (i.e., altruism and compliance) or even just one factor (usually altruism or an overall measure) (Organ and Ryan 1995). In the current study, the Smith et al. (1983) two-factor measure of OCBs was used in the employee survey. Their measure examines both OCB altruism (i.e., direct helping behavior) and compliance (i.e., adherence organizational policies) on 7-point Likert scales ranging from "Strongly Disagree" (1) to "Strongly Agree" (7).

Organizational commitment has been defined as "the strength of an individual's identification with and involvement in a particular organization" (Porter, Steers, Mowday,

and Boulian 1974, p. 604). To examine organizational commitment in Study 2, a scale from Mowday et al. (1979) was used in the employee survey. As in their research, a 15-item measure was used to gauge the organizational commitment of the CSRs. Organizational commitment was measured on 7-point Likert scale ranging from “Strongly Agree” (1) to “Strongly Disagree” (7).

#### *Perceived Service Encounter Quality*

On the employee side of the model, perceived service encounter quality was assessed using an adapted version of the “customer technical quality” and “customer functional quality” scales presented by Kelley et al. (1992). However, slight modifications in the wording were necessary because the original measures were worded and measured from the customer’s perspective. That is, thus far, past research has not provided many measures of employee perceptions of service encounter quality (for an exception see Chandon et al. 1996). In the current study, perceived service encounter quality was measured on 7-point Likert scales examining the social (i.e., functional) and procedural (i.e., technical) performance of customers during recent encounters with CSRs. These items were administered in the employee survey.

#### Measurement Assessment

Prior to administering the measures included in the current research, it was important to establish their validity and appropriateness. While it is not possible for a measure to be completely free of error, it is important to make every effort to minimize as much error as possible (Nunnally 1978). To minimize error, the measurement process should be valid and consistent. In the sections that follow, validity and reliability procedures are discussed further.

#### *Validity*

In general, validity is the “extent to which a measure or set of measures correctly represents the concept of study—the degree to which it is free from any systematic or nonrandom error” (Hair, Anderson, Tatham, and Black 1998, p. 3). A major type of validity is called “construct validity”. Construct validity concerns the extent to which the scores obtained on a measure correspond with the definition of the construct it is designed to represent (Schwab 1999). According to Peter (1981, p. 134), “a measure is construct valid (1) to the degree that it assesses the magnitude and direction of a representative sample of characteristics of the construct and (2) to the degree that the measure is not

contaminated with elements from the domain of other constructs or error.” In both Studies 1 and 2, all of the relevant constructs were examined for validity. In particular, the current research followed the construct validation guidelines specified by Hair et al. (1998). Specifically, measurements were examined for convergent and discriminant validity. While convergent validity appraises the extent of correlation between two measures of the same concept, discriminant validity gauges the extent to which two conceptually related concepts are distinct (Hair et al. 1998).

### *Reliability*

The reliability of a measurement instrument is determined by the degree to which there is internal consistency among the variables in a summated scale (Hair et al. 1998). Put differently, reliability concerns the correlation between a measure and itself (Peter 1981) and the degree to which a measure is free from random error (Nunnally 1978; Schwab 1999). Although reliability is not a sufficient condition for validity (Nunnally 1978), it remains necessary because a valid measure must primarily consist of systematic variance (Peter 1981). One common type of reliability is internal consistency reliability. Internal consistency reliability addresses the consistency obtained from scores on multi-item measures. In both Studies 1 and 2, all multi-item scales were assessed for internal reliability consistency using Cronbach’s alpha (cf., Cronbach 1951).

### Analytical Procedures

In this section, an overview of the procedures for analyzing the research data is presented. For both studies, combinations of exploratory and confirmatory methods were used. Specifically, exploratory factor analysis (EFA) and confirmatory factor analysis (CFA) were used to examine the measurement scales and models. In addition, structural equation modeling (SEM) was used to test the hypotheses proposed in Chapter Three. These procedures are reviewed in the sections that follow.

### *Factor Analysis*

To simplify the measures, EFA was performed on each variable in the two studies. EFA is a method that is used to explore the underlying structure of a set of variables and can also be used as a data reduction technique (cf., Hair et al. 1998; Mertler and Vannatta 2005). In both Studies 1 and 2, variable factor structures were analyzed using the criteria set forth by Hair et al. 1998. In an effort to purify the scales, items that loaded poorly as well as those that loaded on multiple components were deleted prior to conducting further

analyses. EFA was also used when deemed necessary to improve the fit of research models.

To assess the structure of the data, CFA was performed on the variables in Studies 1 and 2. CFA is used to test relationships between observed measures and their underlying factors when researchers postulate these relationships a priori (Byrne 2001). In other words, CFA is used to “confirm” specified associations. In the two studies, CFA was used to validate the structures of the measurement and research models.

#### *Structural Equation Modeling*

Model and hypothesis testing was performed using SEM. This procedure was selected because the purpose of the empirical investigation was to evaluate the patterns of causal relationships among the variables in the research models. SEM allows for the simultaneous testing of a system of separate, but interdependent multiple regression equations that represent a structural model (Hair et al. 1998). The overall objective is to obtain fit between the model and the theoretically hypothesized relationships. The models depicted in Figures 4.1 and 4.2 were each analyzed using SEM procedures.

#### Chapter Summary

This chapter has presented the methodologies used in the current research. Within the contexts of two studies, the employed research settings, research designs, data collection procedures, and operational definitions were discussed. Additionally, the analytical procedures that were used to test the research hypotheses in these two studies were communicated. In the next chapter, the analyses from the two studies are described along with a presentation of the results.

## CHAPTER FIVE: ANALYSIS AND RESULTS

### Introduction

The purpose of this chapter is to present the analysis and results of the two studies that were outlined in the previous chapter. This chapter begins with the results from Study 1 and concludes with the results from Study 2. For each study, the procedures that were used for sampling, data preparation, measurement, model testing, and hypothesis testing are discussed.

### Study 1: Sample Description and Data Preparation

As explained in Chapter Four, the data from Study 1 consisted of internal data taken from the bank's customer experience surveys along with branch-level financial data. The descriptives of the items that were used from the survey and the descriptives of the financial data are respectively shown in Tables 5.1 and 5.2. Both the survey data and the financial data reflected branch performance during the nine month period from April 2008 to December 2008. A total of 156 branches were included in the study which resulted in 1,404 observations in the original data set. However, it was discovered that there was missing data for some of the observations. Cases with missing data were deleted because a good portion of the missing observations occurred in situations where bank branches were newly opened and therefore did not have the data available. In addition the sample size was deemed large enough to afford the elimination of missing cases. With the elimination of missing data, the resulting sample size was 1,271.

Upon further investigation, it was also deemed necessary to eliminate outliers from the data set. Five cases were shown to be extreme outliers and were eliminated. Finally, further investigation revealed that significantly small branches were a major source of outliers and missing data. For example, because branch size was determined by the current number of households, extremely small branches often did not have data available (i.e., small branches may have been new branches) and also had considerably lower levels of financial performance (e.g., lower core deposit, smaller cross sell ratios, etc.). In the current study, descriptive statistics revealed that significantly small branches were those

Table 5.1

## Study 1 Measurement Descriptives

Measure		Mean	S.D.
<b>Customer's Perceptions of Employee Service Encounter Quality<sup>a</sup></b>			
ESEQ1	The employee was friendly.	4.85	.010
ESEQ2	The employee made it easy to do business.	4.77	.130
ESEQ3	The employee gave individualized attention.	4.79	.120
ESEQ4	The employee was knowledgeable about the banks products and services.	4.68	.168
<b>Customer Behavioral Outcomes<sup>b</sup></b>			
BEH1	Customer Loyalty/WOM Index <sup>c</sup>	55%	.100
BEH2	What is your overall satisfaction with the bank?	64%	.097

<sup>a</sup> ESEQ was measured on 5-point Likert scales where 1 indicated "Strongly Disagree" and 5 indicated "Strongly Agree".

<sup>b</sup> Customer Behavioral Outcomes were measured as percentages of reported loyalty and satisfaction.

<sup>c</sup> The Customer Loyalty/WOM Index was a composite of the following items: What is the likelihood that you will continue to do business with the bank? How willing are you to recommend the bank to friends and family?

Table 5.2

## Study 1 Financial Data Descriptives

Measure	Mean	S.D.	Min.	Max.
Net Income (in \$000's)	55.16	211.200	(1,224)	1,660
Efficiency Ratio	86.16	86.920	10	665
Acquisition	.0458	.05175	.00	.40
Retention	979.8981	748.62870	102.00	3793.99
Core Deposits (in \$000's)	23,992.14	18,146.483	473	93,657
Contribution Margin (in \$000's)	213.98	470.361	(263)	3706

that had fewer than 100 current households. Some of these branches were completely eliminated from the analysis while others were retainable for the months when they finally achieved 100 current households. Ultimately, after eliminating missing cases and outliers, the final sample size was 1,235.

All variables in the study were examined for normality. Within the data set, nonnormality was discovered to be most prevalent within the financial data. Specifically, several of the variables did not exhibit normal distribution patterns but instead possessed excessive skewness and/or kurtosis. It was therefore necessary to utilize data transformation procedures. Following the suggested remedies for nonnormality (e.g., Hair et al. 1998; Mertler and Vannatta 2006), these variables were transformed prior to data analysis.

Finally, because a variety of scales were used to measure the variables in Study 1, all responses were converted to standardized scores. The standardization of scores is necessary to permit direct comparisons of variables that have different scales (Hair et al. 1998). While some of the variables in the Study 1 research model were survey responses and were assessed using Likert scales, others were direct measures of financial performance. Using a process in *SPSS*, the scores for each variable were converted into “Z-scores” by subtracting the means and dividing by the standard deviations. That is, raw data scores were transformed into new variables having a mean of 0 and a standard deviation of 1.

#### Study 1: Measurement

The scales in Study 1 were each examined for appropriateness prior to data analysis. EFA procedures were used to judge the convergent and discriminant validity of each measure. Convergent validity is evidenced by appropriate factor loadings for each scale (Hair et al. 1998). This means that each item should load onto the exact factor that it is designated to measure. Convergent validity was achieved with each variable in Study 1.

On the flipside, discriminant validity is evidenced by an absence of cross-loadings. That is, discriminant validity is more concerned with appropriate factor loadings when comparing similar measures. Accordingly, items should not load onto two factors that are measuring similar concepts. In a rigorous examination of discriminant validity using SEM, Anderson and Gerbing (1988) recommend that each pair of latent variables be tested separately by first examining unconstrained correlations between them and then re-

examining the relationship when the correlations are constrained to 1. If the constrained model exhibits inferior fit in comparison to the unconstrained model, discriminant validity can be concluded (Anderson and Gerbing 1988). This technique was used to assess discriminant validity in Study 1. Furthermore, each variable exhibited the desired results.

In addition to validity, each scale was assessed for reliability. Specifically, each measure was tested for internal consistency reliability. Scales were deemed internally consistent if Cronbach's alpha was .70 or higher (Hair et al. 1998). More specific measurement results for each Study 1 variable are discussed in the sections that follow. Additionally, the correlations for the retained items are exhibited in Table 5.3.

#### *Perceived Service Encounter Quality*

Taken directly from the bank's customer experience survey, the scale measuring the customer's perceptions of employee service encounter quality consisted of four items (ESEQ1, ESEQ2, ESEQ3, and ESEQ4). Including all four items, EFA identified a one-factor structure that explained approximately 77 percent of the variance. The factor loadings for each item were high, ranging from .841 to .909. The scale also exhibited high reliability at  $\alpha = .901$ . However, while the fit indices revealed good fit, the chi-square statistic from the CFA conducted on the first-order measurement model revealed poor fit for the ESEQ scale ( $\chi^2_{(2)} = 39.9$  ( $p < .001$ ), CFI = .988, TLI = .964). The modification indices proposed a covariance among two of the error terms. These error terms coincided with items measuring the customer's perception of the employee's knowledge about products and services and whether he or she made it easy to do business. Because an employee's knowledge should make transactions easier, it would appear that a covariance among these two items is rational. With the addition of this covariance, the respecified model achieved good fit ( $\chi^2_{(1)} = 0.167$ , ( $p = .683$ ), CFI = .973, TLI = .964).

TABLE 5.3

Correlations for Indicators in Study 1 Model

Indicator	1	2	3	4	5	6	7	8	9	10	11	12
1. ESEQ1	1.000											
2. ESEQ2	.723**	1.000										
3. ESEQ3	.734**	.744**	1.000									
4. ESEQ4	.620**	.717**	.633**	1.000								
5. BEH1	.414**	.478**	.441**	.498**	1.000							
6. BEH2	.404**	.480**	.469**	.497**	.859**	1.000						
7. TCP1	(.80)**	0.008	(0.056)**	0.016	(.128)**	(.126)**	1.000					
8. TCP2	.122**	0.041	.097**	0.021	.175**	.197**	(.664)**	1.000				
9. CE1	(.184)**	(.068)*	(.182)**	-0.047	(.193)**	(.250)**	.619**	(.729)**	1.000			
10. CE2	.132**	0.056	.127**	0.013	.199**	0.211**	(.559)**	.708**	(.750)**	1.000		
11. FP1	(.85)**	0.001	-0.040	0.042	(.130)**	(.129)**	.791**	(.724)**	.692**	(.655)**	1.000	
12. FP2	(.150)**	(.061)*	(0.119)**	-0.034	(.216)**	(.226)**	.652**	(.807)**	.817**	(.785)**	.713**	1.000

ESEQ = perceived employee service encounter quality; BEH = customer outcome behaviors; TCP = transactional customer profitability; CE = customer equity; FP = financial performance

\* p < .05

\*\* p < .01

### *Customer Behavioral Outcomes*

Customer outcome behaviors were measured using a three-item scale (BEH1, BEH2, and BEH3) that was included in the customer experience survey. All three items loaded onto the same component accounting for approximately 79 percent of the variance. Factor loadings ranged from .798 to .936. The scale showed reliability at  $\alpha = .862$ . However, the reliability analysis also revealed that if BEH3 was deleted from the scale, the scale would be more reliable at  $\alpha = .924$ . Further investigation using CFA techniques revealed that the measurement model was saturated and could not be accepted or rejected at zero degrees of freedom ( $\chi^2_{(0)} = 0.0$ , CFI = 1.00). Subsequent analyses with the overall research model further confirmed the need to eliminate BEH3. Because BEH1 and BEH2 were significantly correlated at  $r = .859$  ( $p < .01$ ), only these two items were retained for subsequent analyses.

### *Transactional Customer Profitability*

The transactional profitability of customers was determined by each branch's net income and efficiency ratio. Both variables loaded onto the same factor explaining approximately 83 percent of the variance and were significantly, negatively correlated at  $r = -.664$  ( $p < .01$ ). These results indicate appropriate relationships in that both variables should measure the same component while being negatively associated. That is, high net incomes and low efficiency ratios are indicative of good financial performance.

### *Customer Equity*

To measure customer equity, acquisition and retention rates were calculated for each branch in the study. Again, both measures loaded onto the same factor and explained about 87 percent of the variance. Acquisition and retention were also significantly, negatively correlated at  $r = -.750$  ( $p < .01$ ). A negative correlation between these factors seems plausible in situations where acquisition and retention cost have not achieved balance. When firms focus more efforts on acquiring new customers (e.g., offering incentives), it could backfire with current customers by leaving them feeling underappreciated. Conversely, when firms center their resources on retaining current customers, they may not have the funds available to cover the costly expenses attached to acquisition strategies. Hence, acquisition and retention may sometimes exhibit negative correlations.

### *Financial Performance*

Branch-level financial performance was determined by contribution margin and core deposits. EFA indicated a one-factor solution explaining approximately 86 percent of the variance. The two variables were significantly correlated at  $r = .713$  ( $p < .01$ ). The scale was also highly reliable at  $\alpha = .833$ .

#### Study 1: Structural Equation Model

Model testing for Study 1 was conducted using SEM procedures in the *Amos 16* statistical package. First, overall model fit was examined. The recommendations of Hu and Bentler (1999) were used to examine overall fit. For example, they suggest that the goodness-of-fit index (GFI) and the adjusted goodness-of-fit index (AGFI) perform poorly and should not be used to evaluate model fit (Hu and Bentler 1999). Instead, more robust maximum likelihood measures should be used. Thus, results based on their suggested parameters are reported here.

Results from the overall model revealed a significant chi-square ( $\chi^2_{(49)} = 706.648$ ,  $p < .05$ ), which is indicative of poor fit. Additionally, both the comparative fit index (CFI) of .945 and the Tucker-Lewis index (TLI) of .925 fall a little short of the strict criteria of .95 or higher (Hu and Bentler 1999). The root mean square error of approximation (RMSEA) of .104 exceeds the upper limit of .08 (Browne and Cudeck 1993), or the more stringent limit of .06 (Hu and Bentler 1999). Finally, the standardized root mean square residual (SRMR) is satisfactory at .060 which is well below the recommended threshold of .08 (Hu and Bentler 1999). Taken together, these results did not signify good overall fit for the model. Therefore, model respecification was deemed necessary.

The main suggestion provided by the modification indices was to add a covariance between the error terms of net income and contribution margin. Because both of these variables measure elements of profit, the need for the covariance was reasonable. The addition of the covariance had a significant impact on the fit indices (CFI = .975, TLI = .966, RMSEA = .071, and SRMR = .056). However, the chi-square was discovered to still be significant ( $\chi^2_{(48)} = 343.193$ ,  $p < .05$ ), indicating poor fit. Additionally, no other theoretically appropriate modification recommendations were offered that could bring the chi-square to insignificance. Thus, the overall model for

Study 1 did not achieve the desired chi-square value, but did achieve good fit according to the fit indices. Considering these mixed results, the next logical step was to examine the individual relationships and hypotheses for the variables.

### Study 1: Hypothesis Testing

Six research hypotheses were examined in Study 1 (i.e., H1a, H2b, H2c, H5, and H6). The overall results of the hypotheses are exhibited in Table 5.4. The results are also depicted on the path diagram in Figure 5.1. Hypothesis 1a predicted that customer equity would be positively related to financial performance. This hypothesis was strongly supported ( $\beta = 1.00$ ,  $p < .001$ ). However, the results of this hypothesis revealed a relatively high standardized regression coefficient. Researchers have argued that while this is not necessarily problematic, it could suggest the presence of multicollinearity (Jöreskog 1999). While the items used to measure customer equity and financial performance were highly correlated, further analysis using regression techniques indicated that multicollinearity was not a problem.

Hypotheses 2b-c concerned the determinants of customer equity. Specifically, hypothesis 2b predicted that transactional customer profitability would be positively related to customer equity. This hypothesis was also supported ( $\beta = .971$ ,  $p = .001$ ). Again, due to the high standardized regression coefficient and high correlation between these variables, regression procedures were conducted to examine the potential impact of multicollinearity. Those procedures again indicated that multicollinearity was not a problem in this Study. Hypothesis 2c focused on the relationship between the customer outcome behaviors and customer equity. These behaviors were posited to be positively related to customer equity. As mentioned in Chapter 4, hypothesis 2c involved a combination of customer loyalty and WOM due to the bank's usage of a loyalty/WOM index. Additionally, the bank included customer satisfaction as an outcome measure. Both outcome behaviors (i.e., BEH1 and BEH2) were incorporated to represent the latent variable for overall customer outcome behaviors. Contrary to expectations, the positive relationship between customer outcome behaviors and customer equity was not supported. Instead, the results indicated a significant, negative relationship between these constructs ( $\beta = -.053$ ,  $p < .001$ ). Hypothesis 5 held that perceived service encounter quality would be positively related to transactional customer profitability.

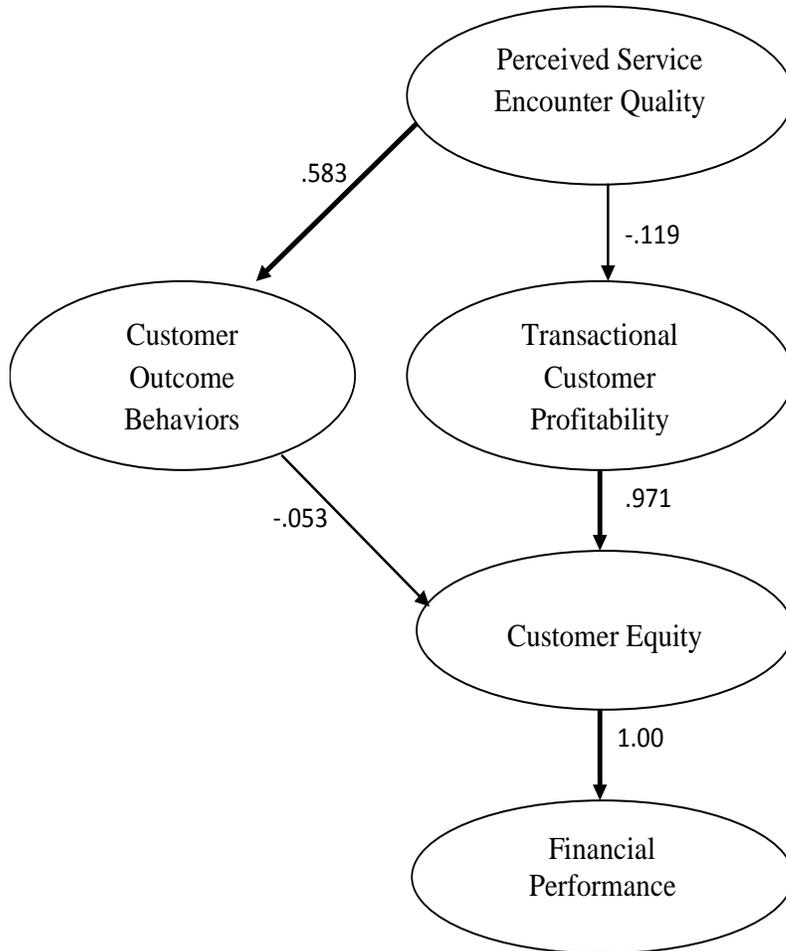
TABLE 5.4

## Summary of Study 1 Hypothesis Results

Hypothesis	Relationship	$\beta$	p-value
H1a	CE $\rightarrow$ FP	( $\beta = 1.00$ )	$p < .001$
H2b	TCP $\rightarrow$ CE	( $\beta = .097$ )	$p = .001$
H2c	COB $\rightarrow$ CE	( $\beta = -.053$ )	$p > .05$
H5	PSEQ $\rightarrow$ TCP	( $\beta = -.119$ )	$p > .05$
H6	PSEQ $\rightarrow$ COB	( $\beta = .584$ )	$p < .001$

CE = Customer Equity, FP = Financial Performance, TCP = Transactional Customer Profitability,  
COB = Customer Outcome Behaviors, PSEQ = Perceived Service Encounter Quality

Figure 5.1  
Study 1 Path Diagram



\* Fit:  $\chi^2_{(48)} = 343.193$ ,  $p < .05$ ; CFI = .975; TLI = .966; RMSEA = .071; SRMR = .056. All structural paths were significant at the  $p < .05$  level or better. Supported hypotheses are represented by bold arrows.

However, this hypothesis was also not supported. Again, a significant, negative relationship was revealed ( $\beta = -.119, p < .001$ ). Finally, hypothesis 6 concerned the relationships between service encounter quality and customer outcome behaviors. Particularly, hypothesis 6 posited that perceived service encounter quality would be positively related to customer loyalty and WOM. This hypothesis was supported ( $\beta = .584, p < .001$ ).

Overall, hypothesis testing revealed both confirmed and unconfirmed relationships. Additionally, a pattern was discovered in which hypotheses were separately supported between variables from the survey and between variables from the financial data, yet no relationships were confirmed among variables across these two methodologies. It was therefore necessary to conduct further analyses to uncover any potential biases resulting from common method variance. Method variance is variance that is caused by the types of methodologies that are employed in a study rather than by the constructs of interest (Bagozzi and Yi 1991). In Study 1, procedures suggested by Podsakoff, MacKenzie, Lee, and Podsakoff (2003) were followed to test for the presence of common method variance. The results of these tests indicated that common method variance may exist in the data; however, substantive structural relationships were not significantly impacted by the variance.

#### Study 2: Sample Description and Data Preparation

Data collection for Study 2 involved a combination of employee surveys and company-generated employee performance data from March, April, and May 2009. The entire survey that was administered in the study is exhibited in the Appendix. Additionally, the descriptives of both the retained items and the performance data are shown in Tables 5.5 and 5.6, respectively. The sample included customer service representatives (CSRs) at a computer services firm that handled in-bound customer service calls. The CSRs that participated took the online survey while at work and gave the researcher permission to obtain their individual performance data from the company. Managers at the site determined when call volume was low enough to allow varying numbers of employees to leave the phones to take the survey. Thus, not all employees had an equal opportunity to participate. A total of 188 respondents completed the online survey. However, it was discovered that 4 of the participants were administrators rather

Table 5.5

## Study 2 Measurement Descriptives

Measure		Mean	S.D.
<b>Employee's Perceptions of Customer's Service Encounter Quality</b>			
CSEQ1	The customer was friendly.	5.30	1.52
CSEQ3	The customer was respectful.	5.48	1.52
CSEQ5	The customer was considerate.	5.26	1.57
CSEQ7	The customer was courteous.	5.23	1.55
CSEQ15	The encounter with this customer was a pleasant experience.	5.21	1.67
<b>Organizational Citizenship Behaviors</b>			
<b>Altruism</b>			
OCB7	I help co-workers who have heavy workloads.	5.00	1.42
OCB12	I assist my supervisor(s) with their work.	4.05	1.76
OCB13	I make innovative suggestions to improve my department.	4.85	1.46
OCB15	I attend functions not required but that help company image.	3.88	1.79
<b>Compliance</b>			
OCB2	I am punctual.	6.07	.941
OCB4	I take underserved breaks.	2.03	1.44
OCB14	I do not take extra breaks.	5.28	1.89
OCB16	I do not spend time in idle conversations.	4.82	1.63
<b>Organizational Commitment</b>			
OC2	I talk up this organization to my friends as a great organization to work for.	4.75	1.96
OC6	I am proud to tell others that I am a part of this organization.	5.11	1.80
OC8	This organization really inspires the very best in me in the way of job performance.	4.68	1.96
OC10	I am extremely glad that I chose this organization to work for over others I was considering at the time I joined.	5.02	1.89
OC14	For me, this is the best of all possible organizations for which to work.	4.28	1.89
OC15	Deciding to work for this organization was a definite mistake on my part.	2.48	1.67
<b>Employee Equity</b>			
EE1	I satisfy customer's service expectations.	6.43	.674
EE2	I manage my work time effectively.	6.43	.702
EE3	I am knowledgeable about my company's services.	6.30	.794
EE4	I know what my customers expect.	6.45	.713

Table 5.6

## Study 2 Performance Data Descriptives

<b>Measure</b>	<b>Mean</b>	<b>S.D.</b>	<b>Min.</b>	<b>Max.</b>
<b>Quality Assurance Ratings</b>				
March QA	96.10%	.0378	78.88%	100%
April QA	96.75%	.0279	81%	100%
May QA	96.80%	.0330	74.88%	100%
<b>Average Call Handle Times</b>				
March AHT	465.08	152.349	203	1049
April AHT	449.68	142.990	183	919
May AHT	441.86	135.439	197	834

than CSRs. These 4 respondents were immediately dropped from further analyses. Of the remaining 184 participants, it was discovered that 17 of the CSRs were recently transferred to the site and therefore had missing employee performance data for all 3 months. Responses from these individuals were also dropped from the data set. Finally, an additional 12 CSRs exhibited patterns of extreme outliers and were eliminated. Ultimately, after eliminating ineligible participants, missing data, and outliers, the final sample size was 155. The demographic characteristics of the survey participants are shown in Table 5.7.

Managing missing data is very important in multivariate analyses. This is especially the case when conducting SEM. In Study 2, it was discovered that there were random cases of missing data particularly among survey responses. This was possibly due to the sampling procedures used in the study. Because of the sample size for Study 2, it was determined that data imputation was the best option for dealing with missing data. Accordingly, linear regression imputation was conducted using *SPSS* (cf., Hair et al. 1998).

As with Study 1, all variables in Study 2 were examined for normality. Excessive levels of skewness and/or kurtosis was apparent with several variables, thus warranting the use of data transformation procedures. Following the suggested remedies for nonnormality (e.g., Hair et al. 1998; Mertler and Vannatta 2006), these variables were transformed prior to further data analysis. Additionally, because a variety of scales were also used to measure the variables in Study 2, all responses were converted to standardized scores (cf., Hair et al. 1998).

#### Study 2: Measurement

Each measure in Study 2 was assessed for appropriateness using the same methods that were applied in Study 1. As mentioned previously, convergent validity is indicated by appropriate factor loadings for each scale (Hair et al. 1998), and discriminant validity is indicated by the absence of cross-loading among similar concepts. For evidence of validity using EFA, factor loadings must be statistically significant. For a sample size of approximately 150, factor loadings must be at least .45 to be considered statistically significant (cf., Hair et al. 1998). As with Study 1, the

Table 5.7  
Study 2 Demographics

<b>Demographic Characteristics of Survey Participants</b>		
<b>N = 155</b>		
	<b><u>Frequency</u></b>	<b><u>%</u></b>
<b>Sex</b>		
Male	30	19.4
Female	125	80.6
<b>Age</b>		
18 to 25	74	47.7
26 to 34	45	29.1
35 and Over	36	23.2
<b>Ethnicity</b>		
Asian	3	1.9
Black/African American	132	85.2
White	5	3.2
Other	15	9.7
<b>Education</b>		
Some High School	1	.6
High School Graduate	47	30.4
Some College	76	49.0
College Graduate	24	17.4
Graduate Degree or Higher	4	2.6
<b>Household Income</b>		
Under \$20,000	63	40.6
\$20,000 to 39,999	72	46.5
\$40,000 to 59,999	14	9.0
\$60,000 and Over	6	3.9
<b>Tenure</b>		
0 to 6 months	16	10.3
7 to 12 months	45	29.1
13 to 18 months	27	17.4
19 to 24 months	33	21.3
25 months and Over	34	21.9

items in Study 2 were checked for correct loadings and constrained versus unconstrained correlations for each pair of latent variables (cf., Anderson and Gerbing 1988).

The results indicated that each variable retained in the model provided adequate convergent and discriminant validity. Additionally, items were assessed for internal consistency reliability using the standard of Cronbach's alpha of .70 or higher. The measurement results for the variables in Study 2 are discussed in further detail in the sections that follow. Additionally, the correlations for the retained items are exhibited in Table 5.8.

#### *Perceived Service Encounter Quality*

In Study 2, perceived service encounter quality was measured from the employee perspective by having employees rate the performance of customers. In this Study, EFA was used in a more confirmatory manner in which the number of factors to be extracted was specified a priori (cf., Hair et al. 1998). In order to parallel the Kelley et al. (1990) measure that was used in this study, the analysis was set to extract two factors. The first factor consisted of seven items (CSEQ1, CSEQ3, CSEQ5, CSEQ6, CSEQ7, CSEQ11, and CSEQ15) and appeared to represent "customer functional quality" (cf., Kelley et al. 1990). The second factor included seven items (CSEQ2, CSEQ4, CSEQ8, CSEQ10, CSEQ12, CSEQ13, and CSEQ14) and seemed to characterize "customer technical quality" (cf., Kelley et al. 1990). One item (CSEQ9) showed slight evidence of cross-loading and was eliminated from the measure. Overall, the loadings for the factors ranged from .508 to .891 and explained approximately 66 percent of the variance.

Within the two-factor structure, both scales were deemed reliable at  $\alpha = .956$  and  $\alpha = .868$ , respectively. However, the reliability analysis indicated that one item (CSEQ11) did not contribute to scale reliability so this item was deleted. The resulting two factors were combined to represent overall perceived service encounter quality. The overall two-factor measurement model revealed inadequate fit ( $\chi^2_{(64)} = 183.228$  ( $p < .001$ ), CFI = .925, TLI = .909). The modification indices suggested a covariance between the error terms for CSEQ4 and CSEQ10 (i.e., "the customer clearly explained what he/she wanted me to do" and "the customer knew what he/she needed before talking with me"), however, the model still did not fit well with this change ( $\chi^2_{(63)} =$

TABLE 5.8

Correlations for Indicators in Study 2 Model

Indicator	1	2	3	4	5	6	7	8	9	10	11	12	13	14	15	16	17	18	19	20	21	22	23	24	25	26	27	28	29	30	31	32	33	34	35	36	37	38		
1. CSEQ1	1.00																																							
2. CSEQ2	.462**	1.00																																						
3. CSEQ3	.816**	.499**	1.00																																					
4. CSEQ4	.373**	.623**	.416**	1.00																																				
5. CSEQ5	.790**	.504**	.865**	.495**	1.00																																			
6. CSEQ6	.683**	.349**	.699**	.441**	.734**	1.00																																		
7. CSEQ7	.833**	.442**	.850**	.433**	.825**	.766**	1.00																																	
8. CSEQ8	.385**	.416**	.411**	.473**	.426**	.490**	.484**	1.00																																
9. CSEQ10	.364**	.555**	.432**	.662**	.458**	.367**	.382**	.406**	1.00																															
10. CSEQ12	.469**	.374**	.515**	.402**	.580**	.578**	.523**	.531**	.437**	1.00																														
11. CSEQ13	.569**	.508**	.618**	.537**	.640**	.572**	.593**	.462**	.541**	.642**	1.00																													
12. CSEQ14	.390**	.326**	.422**	.296**	.469**	.360**	.383**	.363**	.434**	.622**	.509**	1.00																												
13. CSEQ15	.751**	.493**	.810**	.490**	.783**	.719**	.803**	.477**	.472**	.629**	.692**	.541**	1.00																											
14. OCB2	0.10	0.04	0.11	(0.04)	0.04	0.08	0.10	0.04	0.02	0.06	0.05	0.11	0.06	1.00																										
15. OCB4	0.09	(0.02)	0.10	0.04	0.11	0.11	0.12	0.09	(0.06)	0.02	0.03	0.00	0.03	.296**	1.00																									
16. OCB7	0.11	0.01	0.10	0.10	0.11	0.14	0.10	0.00	0.06	.169*	.161*	.210**	0.07	.189*	0.15	1.00																								
17. OCB12	(0.07)	(0.09)	(0.00)	(0.09)	(0.05)	0.04	(0.06)	(0.00)	0.00	(0.01)	(0.09)	0.04	(0.12)	.160*	0.04	.282**	1.00																							
18. OCB13	0.12	.212**	0.12	.227**	0.15	.162*	.167*	.164*	.186*	0.13	0.13	.208**	0.11	.290**	0.12	.394**	.351**	1.00																						
19. OCB14	0.02	0.06	0.01	(0.02)	0.01	0.04	0.02	(0.01)	(0.05)	0.04	(0.02)	(0.01)	0.02	.357**	.391**	0.13	0.183*	.274**	1.00																					
20. OCB15	0.11	0.05	0.14	0.08	0.05	0.08	0.08	0.11	0.01	0.14	0.15	0.10	0.14	0.15	0.15	.354**	.201*	.464**	0.14	1.00																				
21. OCB16	0.03	(0.06)	0.04	0.06	0.03	0.06	0.06	(0.03)	(0.08)	0.00	0.04	0.11	0.07	.242**	.274**	.204*	0.09	.265**	.426**	.293**	1.00																			
22. OC2	.259**	.201*	.189*	.273**	.170*	.247**	.227**	.214**	.231**	.216**	.322**	.177*	.264**	0.01	0.09	0.11	0.03	.167*	0.03	.236**	0.05	1.00																		
23. OC6	.241**	.287**	.213**	.340**	.201*	.302**	.224**	.249**	.272**	.296**	.353**	.229**	.288**	0.04	0.13	.204*	0.00	.169*	0.03	.264**	0.09	.794**	1.00																	
24. OC8	.288**	.327**	.192*	.304**	.217**	.268**	.213**	.281**	.217**	.193*	.276**	.182*	.229**	0.01	.204*	.179*	(0.04)	.186*	0.05	.256**	0.16	.586**	.657**	1.00																
25. OC10	.263**	.233**	.201*	.303**	.201*	.269**	.219**	.233**	.181*	.299**	.345**	.235**	.293**	0.04	0.11	0.14	(0.06)	.189*	(0.02)	.249**	0.09	.631**	.735**	.628**	1.00															
26. OC14	.191*	.254**	0.12	.281**	.182*	.265**	.165*	.292**	.202*	.335**	.369**	.259**	.243**	0.05	0.06	.173*	(0.08)	0.12	0.00	.220**	0.07	.683**	.704**	.599**	0.733**	1.00														
27. OC15	.208**	.256**	0.16	.346**	.178*	.250**	.225**	.199*	.220**	.254**	.299**	.208**	.272**	0.08	0.12	0.14	(0.02)	.230**	0.05	.184*	0.04	.628**	.693**	.493**	0.623**	.564**	1.00													
28. TEP1	0.04	0.06	0.02	0.01	0.03	(0.05)	0.09	0.02	(0.02)	(0.04)	0.03	(0.07)	(0.05)	0.03	(0.08)	(0.03)	(0.04)	(0.05)	0.02	(0.13)	(0.11)	(0.09)	(.210)**	(0.11)	(0.185)*	(.167)*	(0.11)	1.00												
29. TEP2	.161*	0.07	0.15	0.06	0.10	0.11	.160*	0.05	0.13	0.09	0.12	0.07	0.11	0.01	(0.04)	(0.01)	(0.03)	(0.01)	0.02	0.04	0.09	(0.09)	(0.13)	0.00	(0.08)	(0.06)	(0.11)	.416**	1.00											
30. TEP3	0.04	(0.04)	0.02	0.02	0.08	0.10	0.05	(0.04)	0.09	0.09	0.10	0.00	0.04	0.07	(0.09)	(0.08)	(0.02)	(0.00)	0.12	(0.07)	0.07	(0.12)	(0.13)	(0.11)	(0.08)	(0.11)	(0.12)	.352**	.484**	1.00										
31. EE1	.306**	.231**	.307**	0.13	.272**	.180*	.215**	0.15	0.08	.210**	.255**	.188*	.249**	.314**	.255**	.178*	0.06	.252**	.188*	0.15	.247**	.176*	.188*	0.13	0.14	0.16	.196*	(0.08)	0.05	(0.06)	1.00									
32. EE2	.236**	.198*	.266**	0.14	.195*	0.13	0.206*	0.10	0.05	0.12	.208**	0.13	.171*	.417**	.212**	.182*	0.07	.250**	.259**	.192*	.282**	.190*	.251**	.170*	.213**	.178*	.238**	(0.07)	0.03	(0.10)	.741**	1.00								
33. EE3	.245**	.215**	.189*	0.15	0.14	0.09	0.170*	0.12	0.03	0.16	.238**	0.14	.159*	.191*	0.11	.197*	(0.01)	.247**	0.10	.178*	.181*	.204*	.262**	.163*	.240**	.220**	.193*	(0.09)	0.11	(0.08)	.626**	.642**	1.00							
34. EE4	.319**	.307**	.327**	.251**	.244**	.181*	.266**	0.14	0.14	.174*	.292**	0.15	.280**	.265**	.178*	0.11	0.02	.280**	.187*	.237**	.266**	.201*	.239**	.183*	.206**	.173*	.267**	0.00	0.08	(0.07)	.724**	.725**	.659**	1.00						
35. EE5	0.16	0.14	.187*	0.06	0.12	0.03	0.13	0.01	0.10	0.08	0.08	0.10	0.10	.237**	(0.01)	.221**	0.07	.228**	0.09	0.11	.160*	0.01	(0.01)	(0.05)	(0.02)	(0.04)	0.07	0.04	0.07	(0.06)	.586**	.526**	.455**	.518**	1.00					
36. FP1	0.16	0.02	0.11	0.10	.189*	.181*	0.11	(0.01)	0.11	.194*	0.09	0.15	0.14	(.174)*	0.10	0.06	0.00	0.08	0.11	(0.04)	0.07	0.07	0.09	0.02	(0.03)	(0.03)	0.08	(.259)**	(0.07)	(0.15)	0.04	(0.08)	0.08	0.02	0.04	1.00				
37. FP2	.226**	0.07	.164*	0.10	.249**	.237**	.195*	0.05	0.12	.253**	0.13	.183*	.234**	(0.14)	0.12	0.05	(0.02)	0.09	0.12	(0.02)	0.09	0.07	0.08	0.05	(0.01)	(0.04)	0.06	(.249)**	(0.06)	(0.14)	0.10	(0.07)	0.08	0.02	0.00	.895**	1.00			
38. FP3	.171*	(0.04)	0.13	0.05	.192*	.183*	0.15	0.01	0.05	.189*	0.10	0.15	.161*	(0.13)	0.14	(0.04)	(0.03)	0.03	0.11	(0.06)	0.12	0.02	(0.01)	(0.01)	(0.03)	(0.05)	(0.01)	(.276)**	(0.01)	(0.11)	0.10	0.02	0.11	0.05	0.02	.801**	.857**	1.00		

CSEQ = perceived customer service encounter quality; OCB = organizational citizenship behaviors; TEP = transactional employee profitability; EE = employee equity; FP = financial performance

\* p < .05  
 \*\* p < .01

159.029 ( $p < .001$ ), CFI = .940, TLI = .926). If followed, additional modifications based on the suggestions in *AMOS* would have provided better fit indices. However, an insignificant chi-square was not achieved with the two-factor measurement model.

Consequently, further analyses were conducted in which the measurement model was respecified. The results revealed that a one-factor scale using only “customer functional quality” provided the best measure of perceived service encounter quality. This finding indicated that employees relied more on social, relational aspects of the encounter to assess the overall quality of the encounter. The best fitting one-factor scale included five items (CSEQ1, CSEQ3, CSEQ5, CSEQ7, and CSEQ15). The scale was highly reliable at  $\alpha = .956$  and achieved an insignificant chi-square ( $\chi^2_{(5)} = 6.408$  ( $p = .268$ ), CFI = .998, TLI = .997). Therefore, this scale was used in the overall structural model.

#### *Employee Behavioral Outcomes*

Employee behavioral outcomes consisted of OCBs and organizational commitment. The EFA for OCBs was first conducted using an appointed two-factor extraction based on the Smith et al. (1983) measure. However, the two-factor solution exhibited low factor loadings, cross-loadings, only 35 percent explained variance, and low reliability for each scale. It was therefore necessary to eliminate items to improve the two scales. The resulting first factor included four items (OCB7, OCB12, OCB13, and OCB15) and signified “OCB-altruism” (cf., Smith et al. 1983). The second factor also included four items (OCB2, OCB4, OCB14, and OCB16) and represented “OCB-compliance” (cf., Smith et al. 1983). The overall factor loadings ranged from .610 to .786 and explained 51 percent of the variance which falls short of the 60 percent requirement suggested by Hair et al. (1998). However, all items did load onto the correct factors, making convergent validity evident (Hair et al. 1998). The reliability of the scales representing factors 1 and 2 were  $\alpha = .675$  and  $\alpha = .665$ , respectively. While the two scales did not quite meet the .70 recommendation (Hair et al. 1998), researchers have posited that Cronbach’s alpha may sometimes decrease to .60 in exploratory research (Hair et al. 1998; Robinson, Shaver, and Wrightsman 1991). Thus, the reliability of these scales was deemed acceptable. The two factors were combined to represent overall

OCBs. The overall two-factor measurement model revealed good fit ( $\chi^2_{(19)} = 18.327$  ( $p = .501$ ), CFI = 1.000, TLI = 1.005).

Organizational commitment was measured using the Mowday et al. (1979) scale. The initial EFA resulted in a two-factor structure unlike the one-factor model from the original scale. One item (OC12) showed evidence of cross-loading and was eliminated. Only three items loaded onto the second factor (OC3, OC7, and OC9). These items represented the employees' loyalty and potential of leaving the organization. Together, the three-item scale exhibited a low level of reliability at  $\alpha = .425$ . Therefore, a decision was made to drop the second factor and eliminate items based on factor loadings and reliability to improve the fit of a one-factor solution. The resulting scale included six items (OC2, OC6, OC8, OC10, OC14, and OC15). Factor loadings for the scale ranged from .779 to .911 and explained about 71 percent of the variance. The six-item scale was reliable at  $\alpha = .918$ . Additionally, CFA procedures revealed good fit for the measurement model ( $\chi^2_{(8)} = 12.781$  ( $p = .120$ ), CFI = .992, TLI = .986). The error terms for OC10 and OC14 indicated covariance with both assessing the employees' decision to work for the organization.

#### *Transactional Employee Profitability*

An employee's transactional profitability was determined by his or her quality assurance ratings across three months (TEP1, TEP2, and TEP3). Together, the three month quality assurance ratings were reliable at  $\alpha = .706$ . All three items were also significantly correlated and exhibited a one component factor loading that ranged from .749 to .840 and explained approximately 63 percent of the variance.

#### *Employee Equity*

Employee equity was measured based on a self-report measure of job performance. EFA resulted in a one-factor structure that explained 70 percent of the variance. The scale included five items (EE1, EE2, EE3, EE4, and EE5) and was reliable at  $\alpha = .891$ . However, the reliability analysis indicated a higher reliability ( $\alpha = .897$ ) with the elimination of EE5, so it was not retained. Finally, CFA techniques were used to assess the fit of the measurement model. The results implied good fit ( $\chi^2_{(2)} = .553$  ( $p = .758$ ), CFI = 1.000, TLI = 1.012).

### *Financial Performance*

In Study 2, financial performance was determined by the average call handle times of each employee in the sample over a three month time frame. The items for the three months (FP1, FP2, and FP3) provided a highly reliable scale at  $\alpha = .945$ . The one-factor structure contained loadings that ranged from .932 to .967 and explained about 90 percent of the variance.

#### Study 2: Structural Equation Model

The model in Study 2 was tested using SEM procedures in the *Amos 16* statistical package. The overall model resulted in a significant chi-square ( $\chi^2_{(423)} = 500.184$  ( $p = .006$ ), which is indicative of poor fit. Again, model fit was assessed using the recommendations of Hu and Bentler (1999). The results revealed a CFI of .973 and a TLI of .970. Additionally, RMSEA of .034 fell well below the .50 parameter and indicated good fit (Browne and Cudeck 1993). Finally, the SRMR of .075 was also good and fell below the threshold set by Hu and Bentler (1999). Overall, the results suggested that modifications could be made to improve the fit of the Study 2 model.

For instance, according to the modification indices, covariance arrows needed to be added between the error term for overall financial performance and two item error terms (QA1 and OCB2). Since financial performance was measured using average call handle time and quality assurance ratings are partially determined by handle times, this covariance seemed reasonable. In addition, OCB2 (i.e., "I am punctual") was shown to covary with average handle time. Because both of these elements are time-related, the addition of a covariance arrow was deemed appropriate. Implementing these covariances resulted in an insignificant chi-square and overall good fit for the model ( $\chi^2_{(365)} = 409.261$  ( $p = .055$ ), CFI = .983, TLI = .981, RMSEA = .028, SRMR = .071).

#### Study 2: Hypothesis Testing

In Study 2, seven research hypotheses were examined (i.e., H1b, H3b, H3c, H3d, H8, H9a, and H9b). The overall results of the hypotheses are exhibited in Table 5.9 and depicted in Figure 5.2. Hypothesis 1b predicted that employee equity would be positively related to financial performance. However, this hypothesis was not supported ( $\beta = .071$ ,  $p > .05$ ).

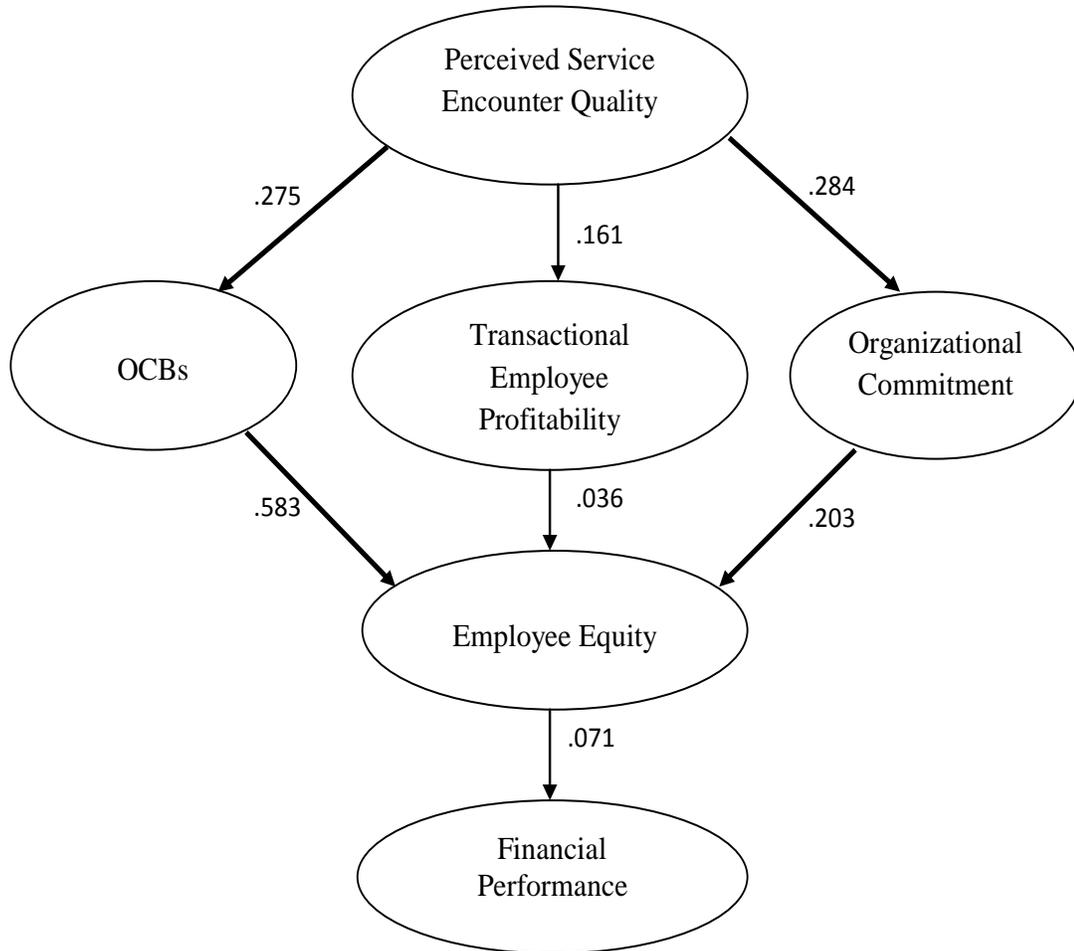
Table 5.9

## Summary of Study 2 Hypothesis Results

Hypothesis	Relationship	$\beta$	p-value
H1b	EE $\rightarrow$ FP	( $\beta = .071$ )	$p > .05$
H3b	TEP $\rightarrow$ EE	( $\beta = .036$ )	$p > .05$
H3c	OCBs $\rightarrow$ EE	( $\beta = .583$ )	$p = .001$
H3d	OC $\rightarrow$ EE	( $\beta = .203$ )	$p < .05$
H8	PSEQ $\rightarrow$ TEP	( $\beta = .161$ )	$p > .05$
H9a	PSEQ $\rightarrow$ OCBs	( $\beta = .275$ )	$p < .05$
H9b	PSEQ $\rightarrow$ OC	( $\beta = .284$ )	$p < .001$

EE = Employee Equity, FP = Financial Performance, TEP = Transactional Employee Profitability, OCBs = Organizational Citizenship Behaviors, OC = Organizational Commitment, PSEQ = Perceived Service Encounter Quality

Figure 5.2  
Study 2 Path Diagram



\* Fit:  $\chi^2_{(365)} = 409.261$ ,  $p = .055$ ; CFI = .983; TLI = .981; RMSEA = .028; SRMR = .071. All structural paths significant at the  $p < .05$  level or better and with supported hypotheses are represented by bold arrows.

Hypotheses 3b-d focused on the three determinants of employee equity. In particular, hypothesis 3b predicted that transactional employee profitability would be positively related to employee equity. This hypothesis was also not supported ( $\beta = .036$ ,  $p > .05$ ). Hypothesis 3c and 3d posited that OCBs and organizational commitment would be positively related to employee equity. As expected, both employee outcome behaviors resulted in significant, positive relationships with employee equity ( $\beta = .583$ ,  $p = .001$  and  $\beta = .203$ ,  $p < .05$ ), respectively.

Hypothesis 8 held that perceived service encounter quality would be positively related to transactional employee profitability. However, the results revealed that this hypothesis was not supported ( $\beta = .161$ ,  $p > .05$ ).

Hypotheses 9a-b concerned the relationships between service encounter quality and employee outcome behaviors. Specifically, hypothesis 9a posited that perceived service encounter quality would be positively related to OCBs, and hypothesis 9b predicted that perceived service encounter quality would be positively related to organizational commitment. Both of these hypotheses were supported ( $\beta = .275$ ,  $p < .05$  and  $\beta = .284$ ,  $p < .001$ ) respectively.

As with Study 1, the confirmation of hypotheses in Study 2 was varied. Likewise, the results of Study 2 also indicated the potential presence of common method variance. Again, the procedures suggested by Podsakoff et al. (2003) were followed and further analyses revealed that while common method variance was present, substantive structural relationships were not significantly impacted.

#### Chapter Summary

In Chapter V, the analysis procedures and results from Studies 1 and 2 were described. For each study, the sampling, data preparation, measurement, model testing, and hypothesis testing procedures were discussed. In the chapter that follows, the overall conclusions and implications from the dissertation are provided.

## CHAPTER SIX:

### CONCLUSIONS AND IMPLICATIONS

#### Introduction

The purpose of this final chapter is to present the conclusions and implications of this dissertation. First, conclusions are provided in reference to the results of the analyses from the previous chapter. Then, implications of those results are offered. Finally, the chapter ends with a discussion of the potential directions for future research.

#### Conclusions

The overall objective of this research was to address the basic question presented in Chapter One: Do interactions between customers and employees lead to outcomes that influence a firm's financial performance? To answer this question, the dynamics of service encounters were investigated as antecedents to customer and employee factors that were proposed to ultimately influence the bottom line. These links were examined from both the customer and employee perspectives. That is, within the contexts of two studies, the overall research model was dissected into conceptually parallel portions to establish direct links from both customer and employee factors to overall financial performance. The conclusions from these studies are discussed in the sections that follow.

#### *Study 1: The Customer Perspective*

In Study 1, survey data and branch-level financial data were examined from the retail banking industry. The dissertation proposed that customers' perceptions of employee service encounter quality would have a positive impact on their outcome behaviors and transactional profitability and, in turn, impact financial outcomes. The overall structural model was tested using SEM procedures. While according to the chi-square test, the results revealed poor fit, the other fit indices suggested that the overall model adequately fit the data. Additionally, several of the hypothesized relationships were supported. Specifically, customer equity was discovered to have a positive impact on overall financial performance (H1a). This finding confirmed past research that has emphasized the importance of maintaining an appropriate balance between acquisition and

retention costs (Blattberg and Deighton 1996). In general, the bank branches in the study that successfully balanced these costs also maintained higher core deposits and contribution margins.

The second set of hypotheses (H2b-c) predicted that transactional customer profitability (i.e., net income and efficiency ratio) and customer outcome behaviors (i.e., loyalty/WOM) would be positive determinants of customer equity. While the customer's transactional profitability positively influenced customer equity, the customer's outcome behaviors actually had a negative impact. These results appear to imply that, ordinarily, bank branches that are more transactionally profitable have a more equitable customer base as well. Yet, branches that have good customer loyalty and WOM recommendations do not necessarily realize customer equity. This finding was surprising as past research has suggested that long-term, loyal customers are a major source of profitability (Reichheld and Sasser 1990).

Hypothesis 5 posited that perceived service encounter quality would be positively related to transactional customer profitability. This hypothesis was not supported. However, perceived service encounter quality did show a positive relationship with customer outcome behaviors (H6). This finding is consistent with past research that has indicated that satisfaction with the social and relational aspects of service encounters leads to customer loyalty (e.g., Bloemer and de Ruyter 1999; Butcher et al. 2001; Jayawardhena et al. 2007; Liljander and Mattsson 2002) and WOM behaviors (Boulding et al. 1993; Parasuraman et al. 1991; 1988; Swan and Oliver 1989).

Taken together, the results of Study 1 indicate separate, positive connections among the financial variables and positive connections among the non-financial variables. Conversely, these connections were proposed to link collectively. Instead, transactional customer profitability and customer equity provided confirmed paths to financial performance and customer outcome behaviors were only positively related to perceived service encounter quality. Additionally, the paths linking the non-financial variables to the financial variables were found to be negative. One explanation for these results might be the presence of common method variance. The results showed that the survey items

were not related as hypothesized to the branch-level financial data. Thus, the employment of separate methodologies may have constrained the relationships among the variables.

Past research may also provide an explanation for the findings in Study 1. For example, Storbacka and Luukinen (1994, p. 31-32) indicated that “it has been shown that it is not uncommon for approximately 50 percent of the customers in a retail bank’s customer base to be unprofitable.” With approximately 10 percent of a bank’s customers providing 100 percent of its profit (Storbacka and Luukinen 1994), the financial impact of customer factors is inevitably biased within this setting. Storbacka and Luukinen (1994) further revealed that customer satisfaction has been found to be higher among a retail bank’s most unprofitable customers. Based on the results of Study 1, customers who were most satisfied and loyal and had higher perceptions of service encounter quality were also less valuable from a financial standpoint. These negative relationships could be the result of the fact that less profitable bank customers often make more transactions and therefore require more service encounters than do highly profitable customers. The higher frequency of interactions to facilitate those transactions could lead to increased familiarity between customers and service providers which may ultimately impact outcome behaviors. These negative relationships could also reveal that bank branches with satisfied, loyal customers are not reaping the financial benefits of their good relations. Perhaps these branches need to engage in “customer alchemy” which is the art of transforming less profitable customers into more profitable customers (cf. Zeithaml et al. 2001). Likewise, it is possible that these branches need to “court” their profitable customers more to ensure that they do not defect from the organization.

#### *Study 2: The Employee Perspective*

In Study 2, employees of a computer services firm participated in web-based surveys which were later matched to their individual financial performance records. It was hypothesized that perceived service encounter quality would have a positive influence on employee outcome behaviors and transactional profitability that would then impact financial performance. This model was analyzed using SEM techniques. While the initial model did not fit as specified, a few modifications produced acceptable fit. Thus, the

results of Study 2 provide evidence of potential linkages between service encounters and financial performance within a service employee framework.

Nevertheless, not all of the hypothesized relationships were supported in this study. In particular, the proposed positive relationship between financial performance and employee equity (H1b) was not confirmed. That is, no evidence was provided to verify a positive relationship between job performance and average call handle times. However, it is conceivable that customer satisfaction efforts may often require CSRs to spend longer amounts of time on calls. While longer call handle times are costly to the firm, CSRs that provide superior service that could lead to increased satisfaction are still valuable sources of equity. Thus, uncontrollable factors such as the nature of the service encounter may have hindered this non-supported relationship.

The next group of hypotheses (H3b-d) concerned the determinants of employee equity. While the positive relationship between transactional employee profitability and employee equity was not substantiated, both OCBs and organizational commitment showed positive associations. This means that while the CSRs' quality assurance ratings did not predict their job performance, their performances of OCBs and their commitment to the organization were both sufficient predictors.

Next, it was presumed that perceived service encounter quality would be positively related to transactional employee profitability (H8). Again, no relationship was supported regarding transactional employee profitability. Namely, employees' perceptions of service encounter quality were not significantly related to their quality assurance ratings. Quality assurance ratings are based on service encounters. In Study 2, managers supplied the employee quality ratings and employees provided their perceptions of encounters with customers. The results may reveal that managers and employees consider dissimilar factors when judging service encounters. Furthermore, managers may not account for employee perceptions of customer's behaviors and performances during encounters when evaluating employee quality. Thus, encounter evaluations may need to be broadened to include a more complete representation of service encounter dynamics.

Finally, it was hypothesized that perceived service encounter quality would be positively related to OCBs and organizational commitment (H9a-b). Both relationships

were supported. These findings indicate that interactions with customers influence employee behaviors. Specifically, positive service encounter experiences appear to motivate employees to be “good citizens” and increases their dedication to the firm.

Collectively, the results from Study 2 reveal overall good fit and some support for the individually proposed links in the model. However, as with Study 1, common method variance may have been a problem in Study 2. Specifically, only the relationships among the variables from the survey resulted in confirmed hypotheses. This could indicate that combining survey results with firm performance data caused incorrect associations among the variables in the model.

Yet, taken as a whole, the structural model still supports the proposed system of linkages from service encounters to financial performance according to the fit indices. Therefore, there is some indication of the importance of service encounters as antecedents to outcome behaviors that have critical financial consequences. In Study 2, perceived service encounter quality appears to be vital to factors that make the CSRs more valuable to the computer services firm. The CSRs’ positive responses to good interaction quality lead to their performance of OCBs and increased organizational commitment. These outcome behaviors are highly valuable to service firms and may carry favorable financial implications if they are effectively managed and cultivated.

#### Managerial Implications

Service encounters can be directed to enhance quality perceptions, outcome behaviors, and firm success. Virtually all aspects of the service environment can be managed including customer and employee interactions. Any encounter can be critical to service outcomes (Stern, Thompson, and Arnould 1996). One major finding from both studies was the significant relationship between perceived service encounter quality and both customer and employee outcome behaviors. Service encounters are essential to both parties and present valuable opportunities to establish perceptions that favorably impact post-encounter behaviors. It is therefore imperative that managers endeavor to understand the dynamics of service encounters, encounter perceptions from the perspectives of all involved parties, and the potential outcomes of both favorable and unfavorable interactions. This understanding should lead to the development of appropriate processes

for managing service interactions in ways that will strategically benefit the firm as a whole.

While the current research did not achieve all of the individually specified links from service encounters to financial performance across both studies, a plethora of past research has shown that outcomes such as customer satisfaction (e.g., Aksoy et al. 2008; Anderson et al. 2004), employee satisfaction (e.g., Bernhardt et al. 2000; Heskett et al. 1997), and customer lifetime value (e.g., Gupta et al. 2004; Venkatesan and Kumar 2004) ultimately impact financial performance. Additionally, the structural model in Study 2 did accomplish the overall goal of examining the impact of service encounters on financial performance. Thus the potential financial effects of the proper management of service encounters remain crucial. Managers should consider both the individual relationships between service encounter variables, outcome variables, and financial variables as well as the overall framework that encompasses these associations. It would not be wise to ignore these interconnections in favor of focusing on one major factor such as customer satisfaction. Effective strategic planning must be more all-encompassing to ensure that all consequences are efficiently controlled.

The results from the two studies also collectively reveal that both customers and employees should be viewed as assets to the firm. In Study 1, customer equity was found to positively influence financial performance, and in Study 2, the structural model established positive links between employee factors and financially relevant variables. Therefore, both customers and employees provide potential sources of financial gains. Consequently, it is important for managers to develop portfolios of customers and employees in a manner that will provide substantial equity for the firm. Both parties can be “valuated” to determine how they should be managed and primed to achieve higher levels of profitability. However, the key is that managers must use valuation procedures that include both financial and non-financial factors. The most effectual valuations should represent all aspects of a customer or employee’s value to the firm. Good/bad customers and employees come in many forms and at varying levels of financial profitability. If managers are faced with unprofitable customers and/or employees, attempts should be

made to convert them into valuable assets before deciding to simply dismiss them or allowing them to defect to other organizations.

### Future Research

In pursuing the goal of making marketing more financially accountable, future research should focus on a deeper investigation into the links between service encounters and firm financial performance. The current research was conducted within the retail banking and computer services contexts. Both service encounter and financial performance characteristics vary depending on the industry. Therefore, it would be worthwhile to test the current models in other service settings to test the generalizability of the results and to better establish the proposed relationships. Additionally, the current research investigated specific customer and employee factors as connectors between service encounters and financial performance. An abundance of other variables are likely to account for associations between these concepts. Hence, future research should consider the financial impact of other customer and employee factors within similar frameworks.

Even after decades of service research, service researchers still favor examinations of the antecedents and consequences of customer factors over those of employee factors. Thus, future research should further investigate relationships between service encounters and employee outcomes. In Study 2, the hypothesized relationships between perceived service encounter quality and employee outcome behaviors and employee outcome behaviors and employee equity were strongly supported. Future research might explore the importance of service encounters to the performance of OCBs and commitment to the organization. For the most part, OCBs and organizational commitment have been posited to result from organizational factors rather than customer interactional factors (e.g., Paulin et al. 2006; cf., Organ and Ryan 1995; Smith et al. 1983). In light of the current research, one might ask: Do positive interactions with customers compel employees to be better employees? How might customers bring out the best in employees? Are OCBs and organizational commitment determined more by organizational factors or interactional factors? Does perceived service encounter quality affect employee job satisfaction? Should employees be valued based on non-financial factors?

Finally in this dissertation, the proposed link between perceived service encounter quality and financial performance was posited to flow through a system of linkages with customer and employee factors. This framework was based on past theory and literature. However, perhaps a more direct path between perceived service encounter quality and financial performance is warranted. Just like service quality and satisfaction have been directly related to the bottom line, maybe service encounter quality also has direct financial consequences. In fact, this path could even go in the opposite direction where financial performance impacts perceived service encounter quality. Storbacka and Luukinen (1994) suggested that rather than having customer satisfaction leading to financial performance, financial factors such as high volumes of customer purchases could lead to satisfaction in a retail bank setting. Hence, future research should examine a variety of direct and indirect linkages between service factors and financial performance as well as other potential directions for the relationships within the network of associations.

## APPENDIX A

### Study 2 Cover Letter and Questionnaire

## Employee Job Perceptions and Job Performance Study

This study gathers employee perceptions regarding their jobs and their interactions with customers along with employee job performance data to examine the overall value of service employees to organizations. You are being invited to take part in this research because your experiences and opinions are of significant interest to marketing academic research and will provide valuable information for a dissertation project. This study investigates employee perceptions of several aspects of their jobs including encounters with customers, day-to-day job activities, and overall opinions about their jobs. In addition, data will be gathered to examine employee skills and levels of job performance to provide a complete assessment of the value of employees.

The current study will be administered to hundreds of employees within your organization. Your information will be combined with information from other people taking part in the study. When I write about the study to share it with other researchers, I will write about the combined information and you will not be identified in these written materials. I may be required to show information which identifies you to people who need to make sure I have done the research correctly; these would be people from such organizations as the University of Kentucky. I may also publish the results of this study; however, I will keep your name and other identifying information private. I am only interested in an overall assessment of employees and will therefore have no reason to look at participants individually. In addition, your individual survey responses will not be shared with anyone in your organization. Only the combined survey results will be disclosed to managers. These results could aid managers in making improvements in the areas of customer service, training, employee relations, and daily operations.

Agreeing to participate in this study requires two things. First, you will take part in an internet survey that should take approximately 15 minutes to complete. Second, by agreeing to participate, you will be providing me with permission to examine your employee evaluation and job performance data such as your call handle time and call quality assessments. This information will be used to provide a well-rounded view of employee performance that includes employee perceptions and opinions, manager perceptions and opinions, and actual performance data. Again, your information will not be assessed on an individual basis, but will instead be combined with that of all of the other study participants.

Your participation in this research is strictly voluntary. Your decision whether or not to participate will not have any impact on your employment. You may skip questions that you do not want to answer or stop participating at any time. Your participation is greatly appreciated. Findings from the study have the potential to be used in educating both students and managers on how to better respond to employee and customer needs.

If you have any questions concerning this study or your rights as a participant, you may contact me, Carla Y. Childers, at (859) 257-2962 or my research advisor, Dr. Scott W. Kelley at (859) 257-3425. You may also contact the staff in the UK Office of Research Integrity at (859) 257-9428 or toll-free at 1-866-400-9428.

Thank you for your willingness to participate in this study.

### A STUDY CONDUCTED BY:

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**Thinking about your most recent service encounter with a customer, please indicate the extent to which you agree or disagree with the following statements regarding the encounter:**

	Strongly Disagree	Disagree	Somewhat Disagree	Neither Agree nor Disagree	Somewhat Agree	Agree	Strongly Agree
The customer was friendly	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
The customer gave me proper information.	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
The customer was respectful.	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
The customer clearly explained what he/she wanted me to do.	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
The customer was considerate.	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
The customer built a good relationship with you.	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
The customer was courteous.	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
The customer kept accurate records.	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>

**Thinking about your most recent service encounter with a customer, please indicate the extent to which you agree or disagree with the following statements regarding the encounter:**

	Strongly Disagree	Disagree	Somewhat Disagree	Neither Agree nor Disagree	Somewhat Agree	Agree	Strongly Agree
The customer was honest.	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
The customer knew what he/she needed before talking with me.	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
The customer was cooperative.	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
The customer understood the procedures associated with this service.	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
The customer was helpful.	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
The customer knew what to do to receive this service.	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
The encounter with this customer was a pleasant experience.	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>

**Please indicate the extent to which you agree or disagree with the following statements regarding your day-to-day job at XYZ:**

	Neither						
	Strongly Disagree	Disagree	Somewhat Disagree	Agree nor Disagree	Somewhat Agree	Agree	Strongly Agree
I help co-workers who have been absent.	<input type="radio"/>						
I am punctual.	<input type="radio"/>						
I volunteer for things that are not required.	<input type="radio"/>						
I take undeserved breaks.	<input type="radio"/>						
I help orient new employees even though it is not required.	<input type="radio"/>						
My attendance at work is above the norm.	<input type="radio"/>						
I help co-workers who have heavy workloads.	<input type="radio"/>						
I coast toward the end of the day.	<input type="radio"/>						

**Please indicate the extent to which you agree or disagree with the following statements regarding your day-to-day job at XYZ:**

	Neither						
	Strongly Disagree	Disagree	Somewhat Disagree	Agree nor Disagree	Somewhat Agree	Agree	Strongly Agree
I give advance notice if I am unable to come to work.	<input type="radio"/>						
I spend a great deal of time with personal phone conversations.	<input type="radio"/>						
I take unnecessary time off work.	<input type="radio"/>						
I assist my supervisor(s) with their work.	<input type="radio"/>						
I make innovative suggestions to improve my department.	<input type="radio"/>						
I do not take extra breaks.	<input type="radio"/>						
I attend functions not required but that help company image.	<input type="radio"/>						
I do not spend time in idle conversations.	<input type="radio"/>						

**Please indicate the extent to which you agree or disagree with the following statements regarding XYZ:**

	Neither						
	Strongly Disagree	Moderately Disagree	Slightly Disagree	Disagree nor Agree	Slightly Agree	Moderately Agree	Strongly Agree
I am willing to put in a great deal of effort beyond that normally expected in order to help this organization be successful.	<input type="radio"/>						
I talk up this organization to my friends as a great organization to work for.	<input type="radio"/>						
I feel very little loyalty to this organization.	<input type="radio"/>						
I would accept almost any type of job assignment in order to keep working for this organization.	<input type="radio"/>						
I find that my values and the organization's values are similar.	<input type="radio"/>						

**Please indicate the extent to which you agree or disagree with the following statements regarding XYZ:**

	Neither						
	Strongly Disagree	Moderately Disagree	Slightly Disagree	Disagree nor Agree	Slightly Agree	Moderately Agree	Strongly Agree
I am proud to tell others that I am a part of this organization.	<input type="radio"/>						
I could just as well be working for a different organization as long as the type of work was similar.	<input type="radio"/>						
This organization really inspires the very best in me in the way of job performance.	<input type="radio"/>						
It would take very little change in my present circumstance to cause me to leave this organization.	<input type="radio"/>						
I am extremely glad that I chose this organization to work for over others I was considering at the time I joined.	<input type="radio"/>						

**Please indicate the extent to which you agree or disagree with the following statements regarding XYZ:**

	Neither						
	Strongly Disagree	Moderately Disagree	Slightly Disagree	Disagree nor Agree	Slightly Agree	Moderately Agree	Strongly Agree
There's not too much to be gained by sticking with this organization indefinitely.	<input type="radio"/>						
Often, I find it difficult to agree with this organization's policies on important matters relating to its employees.	<input type="radio"/>						
I really care about the fate of this organization.	<input type="radio"/>						
For me, this is the best of all possible organizations for which to work.	<input type="radio"/>						
Deciding to work for this organization was a definite mistake on my part.	<input type="radio"/>						

**How satisfied are you with each of the following facets of your job:**

	Very Dissatisfied	Dissatisfied	Neutral	Satisfied	Very Satisfied
Your overall job	<input type="radio"/>				
Your fellow workers	<input type="radio"/>				
Your supervisor(s)	<input type="radio"/>				
Your organization's policies	<input type="radio"/>				
The support provided by your organization	<input type="radio"/>				
Your salary or wages	<input type="radio"/>				
Your opportunities for advancement with this organization	<input type="radio"/>				
Your organization's customers	<input type="radio"/>				

**Please indicate the extent to which you agree or disagree with the following statements regarding your job:**

	Neither						
	Strongly Disagree	Disagree	Somewhat Disagree	Agree nor Disagree	Somewhat Agree	Agree	Strongly Agree
I feel strongly about improving the service my company provides to its customers.	<input type="radio"/>						
I gain a sense of personal accomplishment in providing quality services to customers.	<input type="radio"/>						
I am willing to put in a great deal of effort to help my company deliver high-quality service to our customers.	<input type="radio"/>						
I really care about the quality of my company's services.	<input type="radio"/>						
I enjoy discussing quality-related issues with people in my company.	<input type="radio"/>						

**How would you rate your call performance in the following areas:**

	Neither Poor nor Somewhat				
	Very Poor	Somewhat Poor	Good	Good	Very Good
Your call handle times	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
The accuracy of the information you provide to customers	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
Your voice tone and speech pattern	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
Your overall handling of customers	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
Your overall call quality	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>

**Please indicate the extent to which you agree or disagree with the following statements regarding your job performance:**

	Strongly Disagree	Disagree	Neither Agree nor Disagree	Agree	Strongly Agree
I demonstrate the technical knowledge and skills necessary to perform my job duties and responsibilities.	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
I maintain a high level of personal productivity.	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
I complete assignments with a high level of accuracy.	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
I effectively plan and organize my work to achieve job-related objectives.	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
I consistently adhere to company policies and procedures.	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>

**Please indicate the extent to which you agree or disagree with the following statements regarding your job performance:**

	Strongly Disagree	Disagree	Neither Agree nor Disagree	Agree	Strongly Agree
I demonstrate a high level of communication skills.	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
I develop solid working relationships within my department.	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
I readily adapt to new responsibilities or changes in assignments.	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
I understand customer expectations.	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
I demonstrate creativity and resourcefulness in developing better ways to accomplish assignments.	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>

**Please indicate the extent to which you agree or disagree with the following statements regarding your job performance:**

	Strongly Disagree	Disagree	Neither Agree nor Disagree	Agree	Strongly Agree
I have knowledge of and use tools appropriate to perform my job.	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
I work well under the pressure of heavy workloads.	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
I focus on continuous improvement in all aspects of my job.	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
I manage time well and meet deadlines.	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
I exhibit initiative and require minimum supervision.	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>

**Please indicate the extent to which you agree or disagree with the following statements regarding your job performance:**

	Strongly Disagree	Disagree	Neither Agree nor Disagree	Agree	Strongly Agree
I am an effective listener.	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
I contribute actively to the achievement of team goals and objectives.	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
I am open to new ideas and willing to try new approaches.	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
I consistently place customer satisfaction as a top priority.	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
I gather all relevant information before making a decision.	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>

**Please indicate the extent to which you agree or disagree with the following statements regarding your job performance:**

	Neither						
	Strongly Disagree	Disagree	Somewhat Disagree	Agree nor Disagree	Somewhat Agree	Agree	Strongly Agree
I satisfy my customer's service expectations.	<input type="radio"/>						
I manage my work time effectively.	<input type="radio"/>						
I am knowledgeable about my company's services.	<input type="radio"/>						
I know what my customers expect.	<input type="radio"/>						
I am good at my job.	<input type="radio"/>						

**For the following questions, please provide us with your demographic information:**

**Sex:**

Male

Female

**Age:**

Under 18

18-25

26-34

35-54

55-64

65 and over

**Ethnicity:**

- Asian
- Black/African-American
- Hispanic
- Native American
- White
- Other

**Annual household income:**

- Under \$20,000
- \$20,000 - 39,999
- \$40,000 - 59,999
- \$60,000 - 79,999
- \$80,000 - 99,999
- \$100,000 and Above

**Highest level of education completed:**

- 8th Grade or Less Some High School
- High School Graduate or Equivalent
- Some College
- College Graduate
- Graduate Degree or Higher

**How long have you worked for XYZ?**

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