The Effects of Differential Methods of Compensation and Employee Empowerment on Customer Satisfaction and Loyalty in Service Recovery

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Abstract

This research examined the effects of varying compensation (refund and replacement) and employee empowerment (empowered and non-empowered) in service recovery situations, using a 2x2 experiment. Analysis was undertaken using mean contrasts and ANOVA’s. Findings suggest that empowerment and refund independently impact on post recovery consumer loyalty and satisfaction, but there is no interaction effect.

Introduction

For service organisations the cost of recruiting new customers is higher than the cost of keeping existing customers. It is therefore important that service providers address service failures, as these have been found to result in; consumers switching service providers (Keaveney, 1995), higher levels of consumer dissatisfaction, and reduced levels of customer loyalty. As such, firms need to have service recovery processes in place, to deal with service failures (Wirtz and Mattila, 2004).

There are various recovery options available to organisations. One activity that can be used to deal with failure is compensation, which includes discounts on prices, refunds, or replacement of services. In addition, recovery activities can be undertaken by the service staff themselves (i.e. empowered staff) or though formal organisational channels (i.e. non-empowered staff). This paper examines the effect of these two recovery activities on two consumer outcomes, as well as interactions between them. We found that both recovery actions enhance customer satisfaction and loyalty, although there was no interaction effect between the two actions.

Service Failure and Service Recovery

Service failures occur when providers are unable to fulfil the real or perceived promises they make to their customers (Swanson and Kelley, 2001). If a service received is below what a customer expects then the service is rated as unsatisfactory (Zhu, Shivkumar and Parasuraman, 2004), i.e. service failure. Literature suggests that service failures are inevitable (eg, Boshoff, 1997), in particular because of the heterogeneous nature of services. This means that the service delivered and customer’s expectations are not the same in two identical service encounters, resulting in service variability.

Bhandari, Tsarenko and Polonsky (2007) suggest that managers need to develop strategies to minimise the unwanted consequences of service failure. Authors, such as DeWitt and Brady (2003), suggest that service recovery helps to put things right when they go wrong, i.e., service recovery can address service failure. To be effective, recovery actions should be planned in a similar way to the provision of any service encounter and recovery actions need to address target specific consumer outcomes (Bamford and Xystouri, 2005). These outcomes
include consumer repurchase intentions, customer satisfaction and loyalty (Smith and Bolton, 2002; Tax, Brown and Chandrashekaran, 1998). Johnston and Fern (1999) found that effective recovery could improve customer loyalty and satisfaction and Ziethamal, Parasuraman and Berry (1990) found effective service recovery increases customers’ willingness to recommend the firm to others. Studies have also suggested that customers realise that service failures will occur on occasion, but they believe that service providers should proactively resolve any such failure (Andreassen, 2001; Hart, Hesket and Sasser, 1990). Thus, well-designed service recovery processes can turn an angry and frustrated customer into a loyal one (Andreassen, 2001).

Organisations can act in variety ways in order to undertake service recovery activities. For example, managers can develop policies on how to compensate customer who experienced service failure. Similarly organisation can empower employees to act on behalf of organisation quickly and effectively without seeking managerial approval. The following section discusses these two issues in more detail.

**Methods of Compensation**

Compensation is “providing something extra in atonement” (Duffy, Miller and Bexley, 2006, p.114) and can reduce consumers’ negative image of the firm (Wat and Shaffer, 2005). In a social sense, compensation is regarded as a means for achieving an equitable exchange relationship (Alexander, 2002). Zemke (1994) suggested that compensation is a good strategy for restoring equity to an exchange relationship, when one party has been harmed by another. Compensation offers some tangible proof that the service firm is willing to address poor service delivery (Bitner 1990).

In the literature, the most frequently examined forms of compensation are refunds and replacements. For example, Tax, Brown and Chandrashekaran, (1998), Lewis and Spyarakopoulos (2001), and Hoffman, Kelley and Chung, (2003) all found that a cash refund could improve customer retention. Zemke and Bell (1990) also suggested that dissatisfied customers expect reasonable compensation, for example a refund. Other forms of compensation, such as a price discount can also be used in service recovery to improve customers’ repurchase intentions, positive word of mouth, and satisfaction (Boshoff, 1997; Wirtz and Mattila, 2004). Similarly, provision of a replacement service has been identified as another alternative recovery action (Boshoff, 1997; Kelley, Hoffman and Davis, 1993; Lewis and Spyarakopoulos, 2001; Smith, Bolton and Wagner, 1999; Tax, Brown and Chandrashekaran, 1998). According to Hoffman Kelley and Chung, (2003) all types of compensation- a total replacement of service; a correction (e.g. recooked food, fixed torn garment); or substitution (e.g. providing similar product to replace original) - can improve customer satisfaction. As such, it appears that refund and replacement are both important for improving consumer outcomes. Therefore, it is hypothesised that:

H1: Customer satisfaction and loyalty will not differ with varying types of compensation (refund vs. replacement) in a service recovery encounter.

“Empowerment refers to the desire, skills, tools and authority as a frontline employee to offer services to the customer (Zeithaml and Bitner, 2000, p. 302)”. The delivery of a successful service can be achieved when the organisation enabled frontline employees to interact directly with consumers when they face unsatisfactory experiences (Boshoff and Leong, 1998).
The greater the need for service recovery, the more a firm should empower their employees
(1995) suggested that the levels of empowerment impacts customers’ perception of service
performance. In addition, Valenzuela et al., (2005), found that empowerment improves the
working environment by engaging employees at an emotional level. Thus, empowered
employees can potentially better deal with service failure on the spot and improve customer
satisfaction (Tschohl, 1998). As such, empowering employees to respond to failure is an
important service recovery action (Boshoff and Leong, 1998; Goodwin and Ross, 1992).
Therefore, it is hypothesised that:

H2: Customer satisfaction and loyalty will improve when employees are empowered to deal
with service failure.

H3: Employee empowerment and compensation will have an interaction effect on customer
satisfaction and loyalty when dealing with service failure.

The Research Design

This research applied a factorial design using hypothetical service failure scenarios, identical
to those used by other authors, such as Michel (2001), Wirtz and Mattila, (2004), and Yen,
Gwinner and Su, (2004). The design included a (2X2) between subject experimental design,
with four scenarios. The scenarios were refined using a) interviews with service managers, b)
a realism test with undergraduate students, and c) a pre-test with service employees. These
three activities were undertaken to ensure that the scenarios and survey were reliable and
realistic. Each version of the survey was completed by 20 respondents in a block design, i.e.
80 participants overall.

Two levels of employee empowerment (empowered vs. not empowered) and two types of
compensation (refund and replacement) were incorporated in scenarios. An empowered
employee was differentiated from a not empowered employee as “the front desk staff were
able to compensate the customer without seeking their manager’s approval” as compared to
“the front desk staff explained you that they were waiting for their manager’s approval to
compensate you”. Service failure was captured with the statement “…informs you that the
hotel is overbooked and there are no rooms are available”. The dependent variables
measuring loyalty and satisfaction were adapted from Swanson and Kelley (2001) and
Patterson and Smith (2001) and were measured using 7- point Likert-type scales.

<table>
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<tr>
<th>Effect</th>
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<th>Type III Sum of Sq</th>
<th>df</th>
<th>F</th>
<th>Sig.</th>
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Analysis

The analysis firstly undertook a MANOVA to examine multivariate interaction effect. The ANOVA results were used to examine the direct effects of type of compensation and employee empowerment. Secondly, mean comparisons were conducted to identify the direction of the responses (positive vs. negative), when differences were identified in the ANOVAs.

ANOVA were run to examine the effects of empowerment, type of compensation and the interaction between the two (Empowerment*Compensation) in regards to customer satisfaction and loyalty. The results (see Table 1) indicated that there was a significant effect on consumer satisfaction and loyalty with varying methods of compensation as well as the level of empowerment (empowered vs. not empowered). However, the interaction effect, i.e., compensation and level of empowerment, was insignificant for both dependent variables.

Table 2: Mean Contrasts for Satisfaction and Loyalty

<table>
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<tr>
<th>Independent variable</th>
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<th>Mean Diff.</th>
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<th>Not Empowered</th>
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<td>3.2945</td>
<td>3.1363</td>
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</table>

We then sought to explore the direction of differences by comparing the mean values (Table 2). In order to compare the mean values of dependent variables between refund and replacement, independent sample t-tests were conducted where types of compensation served as grouping variable and compensation served as dependent variable. The mean differences for empowerment were also computed using the same approach. The t-test results indicated significant difference in customer satisfaction ($t=9.75, p<.001$) and loyalty ($t=22.61, p<.001$) with compensation as well as customer satisfaction ($t=12.28, p<.001$) and loyalty ($t=5.20, p<.001$) with empowerment. In all cases the mean value associated with refund (vs. replacement) and empowerment (vs. no empowerment) were significantly higher for both satisfaction and loyalty. These results are also presented in Figures 1 and 2 below.

The results support that varying the compensation type does affect satisfaction and loyalty, and thus, H1 is supported. The results also identify that loyalty and satisfaction are higher when a refund is offered as compared to a replacement. Satisfaction and loyalty are also higher in situations were employees are empowering to deal with failure, rather than deferring to managers or others in the organisation. Thus, hypothesis H2 is also supported, which is consistent with the literature suggesting that empowerment will improve consumer outcomes (Wat and Shaffer, 2005; Tschohl, 1998). The results presented in Table 1 suggest H3 should be rejected as there is no statistically significant interaction effect between compensation and empowerment, in regards to satisfaction or loyalty.
Conclusion, Limitations, and Future Directions

The findings of this study suggested that customer satisfaction and loyalty vary with refund (vs. replacement) after a service failure experience. Further, this research also indicated that service customers prefer employees involved in service delivery to be empowered to address service failure, i.e., to undertake recovery actions.

Surprisingly, even though empowerment and refund both independently affected outcomes, there was not any interaction effect between these two actions. This would seem to suggest that, although empowerment is appreciated, consumers are possibly less concerned with who offers compensation (empowered employees or others) as long as they are refunded for the loss experienced. Together, these findings are able to offer some insights for the managers, when they develop service recovery strategies involving compensation and employee empowerment. Specifically, managers should ensure that they offer customers refunds, in order to maintain customer satisfaction and loyalty. Employee empowerment should be implemented, as it seems to improve consumer outcomes, although it does not interact with compensation.

Despite the outcomes of this research, there are limitations that should be noted. This study was based on hypothetical scenarios in one service setting and future research could explore other settings. Further, this research only explored two consumer outcomes, loyalty and satisfaction, and there are a range of consumer outcomes (e.g. future expectation and Word of Mouth referrals) that need to be considered to fully understand service recovery (Bhandari et al., 2007). Similarly, the study only explored situations where some type of compensation was offered, thus the impact of recovery not involving compensation needs to be explored. In addition, there is an opportunity for the future research to investigate the effect of all three types of compensation (refund, replacement and no compensation at all). Finally, the analysis of this study was based on 20 respondents for each scenario and while other studies use similar sample sizes (e.g., Boshoff, 1997; Kelley et al., 1993; Wirtz and Mattila, 2004), larger samples should also be explored.
References


