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# The Hidden Costs of Customer Dissatisfaction

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**Failure to identify the financial impact of customer defection can cost a company millions in potential profits—without anyone knowing. Better understanding of the relationships between customer satisfaction, customer retention, and financial results will lead to improved performance. Three models are presented to help quantify the costs of these relationships.**

In today's competitive business environment, merely satisfying customers is not enough to acquire long-term, repeat customers. A key aspect of managing customer relations is building lasting and positive relationships with customers. Acquiring a new customer can cost up to 10 times as much as supporting an existing customer. The first sale is expensive and time-consuming, involving activities such as advertising, promotion, calls, contacts, demonstrations, and training. It may take many years before a company breaks even on new customers. Credit card companies, for example, lose $50 per customer the first year, while life insurance companies break even after three years.[1]

Loyal customers generate higher profit margins than new customers. Studies indicate that a 5% improvement in customer retention can add anywhere from 25% to 85% to the bottom line.[2] A 10% increase in acquisition costs adds less than 2% to overall customer value (present value of profit streams over customer lifetime with the company), whereas a 10% increase in customer retention adds up to 30% to customer value. The impact of retaining 2% more customers is about the same as cutting costs by 10%.[3]

Because customer satisfaction is difficult to quantify or capture in financial reports, managers frequently fail to identify the full extent of the issue. Since satisfied customers also defect sometimes, erroneously equating customer satisfaction with customer retention can lead to disappointing results and the loss of potential profits. To provide a deeper understanding, this article looks at different levels of customer satisfaction and the relationships between customer satisfaction, customer retention, and profit. Also presented are models to estimate the value of customers over time, estimate the cost of lost customers, and measure the impact of improved retention on profits.

### Customer Satisfaction

Customers are the most critical aspect of any business. They are the focal point of a company's operations. They define quality and specify levels of expected performance in a variety of product attributes and features, including cost, functionality, reliability, on-time delivery, prompt resolution of conflicts, and clear, correct, and timely billings.

Yet customer satisfaction is a moving target. What made customers happy today may not make them happy tomorrow. The same attributes that are highly regarded today may lose the ability to excite tomorrow and become routine items. Noriaki Kano, a professor at the Tokyo University of Sciences, classified customer requirements into three levels based on their importance to and impact on satisfaction: threshold attributes (dissatisfiers), performance attributes (satisfiers), and delighting attributes (exciters).[4]

Threshold attributes are the attributes needed to meet basic and minimal expectations. These attributes must be present for the product or service to be acceptable to customers. Adding more threshold attributes or enhancing the performance of the existing threshold attributes does not increase customer satisfaction. Customers remain neutral toward the product or service. While the threshold attributes do not help create product differentiation or help sell the product, their absence or poor performance result in immense dissatisfaction. Their absence will prevent customers from buying the product or service in the future. For example, customers do not openly express that they want brakes, heaters, and radios in automobiles or paper in washrooms, but one can readily imagine the customer dissatisfaction if these items are not present.

Performance attributes are the functions and features of products and services that directly correlate with customer satisfaction. Customers value these attributes, openly express interest in having these items, and will not mind paying a premium for them. An example is the willingness of customers to pay more for hybrid automobiles, such as the Toyota Prius, during a time when gas prices increase significantly.

Improving the quantity and quality of these attributes increases customer satisfaction, while the lack of these attributes, a lower quality, or inferior performance diminishes customer satisfaction. Designing products and processes with new performance attributes (such as tilting steering wheels) and enhancing existing performance attributes (such as increasing fuel efficiency) greatly improve customer satisfaction.

Delighting attributes, the highest level of attributes, are the unspoken and unexpressed needs and desires of customers. These are the functions or features that add value and increase satisfaction but which customers are unaware of or do not actively seek. Examples of delighting attributes in a car might be rear-view cameras or automated parking assistance. When deciding on what kind of car to buy, customers generally do not think about backing up or parking, yet they feel delighted when they find that the car has such attributes. Delighting attributes create a pleasant surprise in customers—a "wow" feeling—and generate a sense of higher value. While their absence may not have much impact on customer satisfaction or the product's performance, their presence results in superior levels of customer satisfaction. In a competitive marketplace where several companies provide products or services with compatible functions, features, and performance, delighting attributes provide significant competitive advantages.

As customers become accustomed to delighting attributes and begin to expect them as routine product features, they become performance attributes. Eventually, customers begin to take them for granted, and the performance attributes become threshold attributes or minimal expectations and a price of entry. For example, cup holders in cars no longer necessarily delight customers, but their absence can definitely irritate passengers who are used to having them.

For a product to remain competitive, it must meet all threshold attributes, maximize performance attributes, and contain as many delighting attributes as possible within the cost and time constraints that the market can bear.

### Relationships Between Customer Satisfaction, Retention, and Profit

Profit is the result of customer satisfaction. Customer satisfaction is the result of the functions and features of a product or service as perceived and valued by customers. Value and quality of services are the result of the efficiency and effectiveness of internal processes, employee knowledge and skills, and how customer relations are managed. Customer loyalty is the result of higher levels of satisfaction, which generate enthusiasm, which in turn make customers repeatedly and consistently spend significant amounts of their available budget on goods or services from a specific brand. For example, the loyal customers of McDonald's spend almost all their fast food budget on McDonald's products. Many in the food industry refer to this as "share of stomach" or "stomach share."

Satisfied customers buy more products and pursuade others to buy the same brands, while dissatisfied customers switch brands and tell others about their negative experiences. TARP (Technical Assistance Research Program) Worldwide, a consulting firm, has found the following facts regarding customer satisfaction:

- The average business never hears from 96% of its unhappy customers.
- For every complaint received, the average company has 26 customers with problems—six of which are "serious."
- Complainers are more likely than noncomplainers to do business again with the company that upset them even if the problem is not resolved satisfactorily.
- 54%-70% of customers who register a complaint will do business again with the organization if the complaint is resolved. That figure goes up to a staggering 95% if the customer feels that the complaint was resolved quickly.
- A satisfied customer tells eight people, whereas a dissatisfied customer tells 22.[5]

The benefits of customer loyalty include lower marketing costs, broader sales opportunities, sales of premium-priced items, additional sales through word of mouth, and a better customer/supplier partnership. As customers become acquainted with products and their vendors, they feel comfortable and buy more and higher-priced items. As shown in Table 1, a 5% reduction in customer defection could improve profits by 25% in the credit insurance industry and up to 85% in branch deposits.[6]

Companies often spend a great deal of time and money on finding and acquiring new customers compared to retaining existing customers. Yet that is not enough to achieve superior results. The profit margins of new and long-term customers are very different. Profit generated by long-term loyal customers increases in a nonlinear manner. For example, credit card compa-

Table 1. **Impact of 5% Reduction of Customer Defection on Profit**

| Industry | Profit Improvement |
|---|---|
| Auto Service Chain | 30% |
| Branch Deposits | 85% |
| Credit Card | 75% |
| Credit Insurance | 25% |
| Insurance Brokerage | 50% |
| Industrial Distribution | 45% |
| Industrial-Building Management | 40% |
| Software | 30% |

Source: Frederick Reichheld and W. Earl Sasser, Jr., "Zero Defections: Quality Comes to Services," *Harvard Business Review*, September 1990, pp. 105-111.

## Table 2. **Impact of Customer Loyalty on Profit**

| Industry | Year 1 | Year 2 | Year 3 | Year 4 | Year 5 | Change from Year 1 to Year 5 |
|---|---|---|---|---|---|---|
| Industrial Distribution | $45 | $99 | $121 | $144 | $168 | 273% |
| Auto Servicing | $25 | $35 | $70 | $88 | $88 | 252% |
| Credit Card | ($51) | $30 | $42 | $45 | $55 | *** |
| Industrial Laundry | $144 | $166 | $192 | $222 | $255 | 77% |

Source: Frederick Reichheld and W. Earl Sasser, Jr., "Zero Defections: Quality Comes to Services," *Harvard Business Review*, September 1990, pp. 105-111.

## Table 3. **Impact of Retention Rate, Acquisition Cost, and Cost Margin on Customer Value**

| Company | Customer Value: Base Case (in $B) | % Increase in Customer Value for 10% Improvement in Retention | % Increase in Customer Value for 10% Improvement in Acquisition | % Increase in Customer Value for 10% Improvement in Cost Margin |
|---|---|---|---|---|
| Amazon | $2.54 | 28.34% | 0.51% | 10.51% |
| Ameritrade | $1.45 | 30.18% | 1.19% | 11.19% |
| eBay | $2.11 | 30.80% | 1.42% | 11.42% |
| E-Trade | $1.89 | 29.96% | 1.11% | 11.11% |

Base case: 70% customer retention, 12% discount (Source: Sunil Gupta and Donald R. Lehmann, "What Are Your Customers Worth?" *Optimize*, May 2002.)

nies lose money on new customers. As shown in Table 2, fifth-year customers of auto service companies produce 252% more profit than first-year customers [(88-25)/25]. Similarly, fifth-year customers of industrial distribution bring a profit that is 273% of first-year customers [(168-45)/45]. Similar trends were found in more than 100 companies in two dozen industries.[7] The cost of getting new customers can be as high as 5-10 times the cost of retaining existing customers. According to TARP data, the acquisition cost of a new automobile customer was $750 compared to the goodwill cost of $150 to retain an existing customer.

Low-defection strategies show more promise than low-cost strategies. Table 3 shows the impact of three different strategies: (1) improving customer retention, (2) decreasing acquisition cost, and (3) improving cost margins on customer value. A 10% improvement in customer retention improves customer value as much as 28%-31%, whereas a 10% reduction in acquisition cost improves customer value by only 0.5%-1.4%.[8] Profitable companies find ways to retain existing customers and grow their market share with new ones. Unfortunately, today's accounting systems do not measure the costs and benefits of customer satisfaction or the value of loyal customers.

## Measuring and Reporting the Cost of Customer Dissatisfaction

When customer dissatisfaction goes unnoticed, it can slowly kill a company. Because of the intangible nature of customer dissatisfaction, managers regularly underestimate the magnitude of customer dissatisfaction and its impact on the bottom line. Part of the problem is the current inadequacy of accounting systems. Accounting systems have sophisticated methods to measure the value of capital assets, but they have practically none to measure and value customer loyalty, a critical asset. With the focus on current period costs and revenues, accounting systems ignore expected cash flows over a customer's lifetime and treat customer acquisition costs as current expenses rather than assigning them to a capital account and amortizing them over a customer's lifetime loyalty to the company.

While there are no precise ways to measure customer dissatisfaction, companies can make rough estimates of lost customers and lost profits. Here are three models that translate customer acquisition, customer retention, and customer defection into dollars. Each model is described using Alpha Company (a fictitious company) as an example. The first model estimates the costs of acquisition and retention; the second looks at customer complaint resolution and the potential loss of customers; and the third calculates customer lifetime value. While these estimates are not perfect, they provide reasonable and relevant information to help managers gain a better understanding of these costs and make better decisions.

### *Model 1: Estimating Acquisition and Retention Costs*

Alpha Company sells in a highly competitive market. Several companies sell very similar products, and customers often switch brands. Currently Alpha has 100,000 customers, which represents a 10% market share.

Alpha's profits were satisfactory for a long time, but they have started to slip in recent years. Top managers were somewhat baffled with the declining profit margins despite stable market share and declining product costs. Marketing department managers were unable to provide any answers except explaining that they have been doing everything possible to maintain their market share and are aggressively pursuing new customers. The Accounting department was not much help either. The Customer Relations department provided data indicating that Alpha's customer satisfaction level remained strong. The Manufacturing department indicated that it was able to continuously reduce product costs through the use of lean principles and continuous improvements.

To get to the bottom of the issue, Alpha Company created a Customer Relations Management (CRM) team consisting of members from the Marketing, Accounting, and Customer Service departments. This team collected a lot of data and identified some significant facts, including:

- Customer base: 100,000
- Market Share: 10%
- Retention rate: 80%
- Average cost to acquire a new customer: $1,000
- Average cost of retaining a first-year customer: $200
- Average cost of retaining customers beyond the first year declines 20% each consecutive year.
- Average profit margin generated by the first-year customer: $2,000
- Average profit margin generated by customers beyond the first year increases 20% each consecutive year.

The team's analysis of customer satisfaction and relevant data revealed some startling information. While the 80% retention rate appeared impressive, Alpha was losing customers and constantly replacing them. Over a period of five years, Alpha retained only 32,768 (about 33%) of the 100,000 customers it had at the beginning of the first year. In other words, Alpha acquired 67,232 customers over the five-year span just to maintain its current market share. Accounting personnel estimated the cost of this ongoing loss and acquisition of customers as $67,232,000 (67,232 × $1,000). Table 4 shows the details of these calculations.

Some team members argued it was not really a loss because the total number of customers was stable. The team next set out to determine if the loss of customers was really detrimental to profits. The data collected indicated that new customers were not as profitable as those who stayed with Alpha for several years. Account-

Table 4. **Customer Retention and Lost Customers with 80% Retention Rate**

| Year | Number of Customers at the Beginning of the Year | Customers Lost During the Year | Cumulative Number of Customers Lost |
|---|---|---|---|
| 1 | **100,000** | 20,000 | 20,000 |
| 2 | 80,000 | 16,000 | 36,000 |
| 3 | 64,000 | 12,800 | 48,800 |
| 4 | 51,200 | 10,240 | 59,040 |
| 5 | 40,960 | 8,192 | **67,232** |
| 6 | **32,768** | | |

Table 5. **Net Present Value of Customer over Time with 80% Retention Rate**

| Year | Profit Margin | Acquisition Cost/Retention Cost | Net Cash Flow | Present Value Factor | Net Present Value | % Increase in NPV Compared First Year |
|---|---|---|---|---|---|---|
| 0 | - | $1,000.00 | ($1,000.00) | 1.000000000 | ($1,000.00) | *** |
| 1 | $2,000.00 | $200.00 | $1,800.00 | 0.892857143 | $1,607.14 | *** |
| 2 | $2,400.00 | $160.00 | $2,240.00 | 0.797193878 | $1,785.71 | 11.11% |
| 3 | $2,880.00 | $128.00 | $2,752.00 | 0.711780248 | $1,958.82 | 21.88% |
| 4 | $3,456.00 | $102.40 | $3,353.60 | 0.635518078 | $2,131.27 | 32.61% |
| 5 | $4,147.20 | $81.92 | $4,065.28 | 0.567426856 | $2,306.75 | 43.53% |

ing members explained to the team how activity-based costing (ABC) demonstrated that not all customers are profitable and that companies may be better off by not having certain customers. This was news to Marketing and Customer Service personnel. It was (and often is) difficult for people in these departments to understand how profit can increase by not selling to certain customers. The team wanted some solid numbers to back up the claim.

Using a 12% discount rate, Accounting personnel calculated the net present value (NPV) of a customer who stayed with the company for one to five years (see Table 5). Profit margin includes all costs other than customer acquisition and customer maintenance costs. The NPV of a first-year customer is $1,607.14. Customers who remained with Alpha for three years show an NPV of $1,958.82, which is about 22% higher. Those who stayed for five years generate an NPV of $2,306.75, which is 44% higher than that of the first-year customer.

Alpha's managers were stunned. They had had no idea of the magnitude of the effect of customer dissatisfaction. They asked the team to come up with ways to improve customer retention. The team explored many ideas and developed a plan that it expects will increase the customer retention rate to 85%. This plan includes activities such as improving employee training, developing better communications with customers, and improving response time and conflict resolution. The estimated cost of the project is $50 million. Expected benefits are shown in Table 6.

Table 6. **Impact of Customer Retention on Profit**

| No. of Years | 80% Retention rate: Customers Lost | Profit per Customer | Potential Profit or Loss | 85% Retention rate: Customers Lost | Profit per Customer | Potential Profit or Loss |
|---|---|---|---|---|---|---|
| 1 | 20,000 | $1,607.14 | $32,142,857.14 | 15,000 | $1,607.14 | $24,107,142.86 |
| 2 | 16,000 | $1,785.71 | $28,571,428.57 | 12,750 | $1,785.71 | $22,767,857.14 |
| 3 | 12,800 | $1,958.82 | $25,072,886.30 | 10,838 | $1,958.82 | $21,228,703.53 |
| 4 | 10,240 | $2,131.27 | $21,824,239.90 | 9,212 | $2,131.27 | $19,633,024.41 |
| 5 | 8,192 | $2,306.75 | $18,896,888.20 | 7,830 | $2,306.75 | $18,062,061.30 |
| **Total** | | | **$126,508,300.11** | | | **$105,798,789.25** |

Increasing the customer retention rate by 5% over a period of five years will result in more than $20 million in additional profit and a return on investment of 41.42%.

Increase in Profit = $126,508,300.11 – $105,798,789.25 = $20,709,510.86

$$\text{Return on Investment} = \frac{\$20,709,510.86}{\$50,000,000.00} = 41.42\%$$

***Model 2: Complaint Resolution and Loss of Customers***

The number and nature of customer complaints and how they are resolved play a significant part in customer satisfaction and retention. While it may be difficult to believe, customers with satisfactory resolution of complaints showed 8% or more loyalty compared to those who had no problems at all.[9] Alpha's customer retention team studied the patterns of customer behaviors when there were problems and when there were no problems. It also gathered data on the percentage of customers who bought from Alpha again after previously having a problem. The team came up with the following estimates:

- 70% of customers experience no problems; 90% of those customers will buy from Alpha again.
- Of the 30% who experience problems, half will report the problems; 60% of the reported problems will be resolved satisfactorily.
- 80% of those who have had problems resolved and 25% of those who have not had a problem resolved satisfactorily will buy from Alpha again.
- 60% of customers who experience a problem but do not report it will buy from Alpha again.

This model estimates the number of potential lost customers by using past experience, data gathered regarding the numbers and the corresponding probabilities of various scenarios, and tree diagrams (see Figure 1).

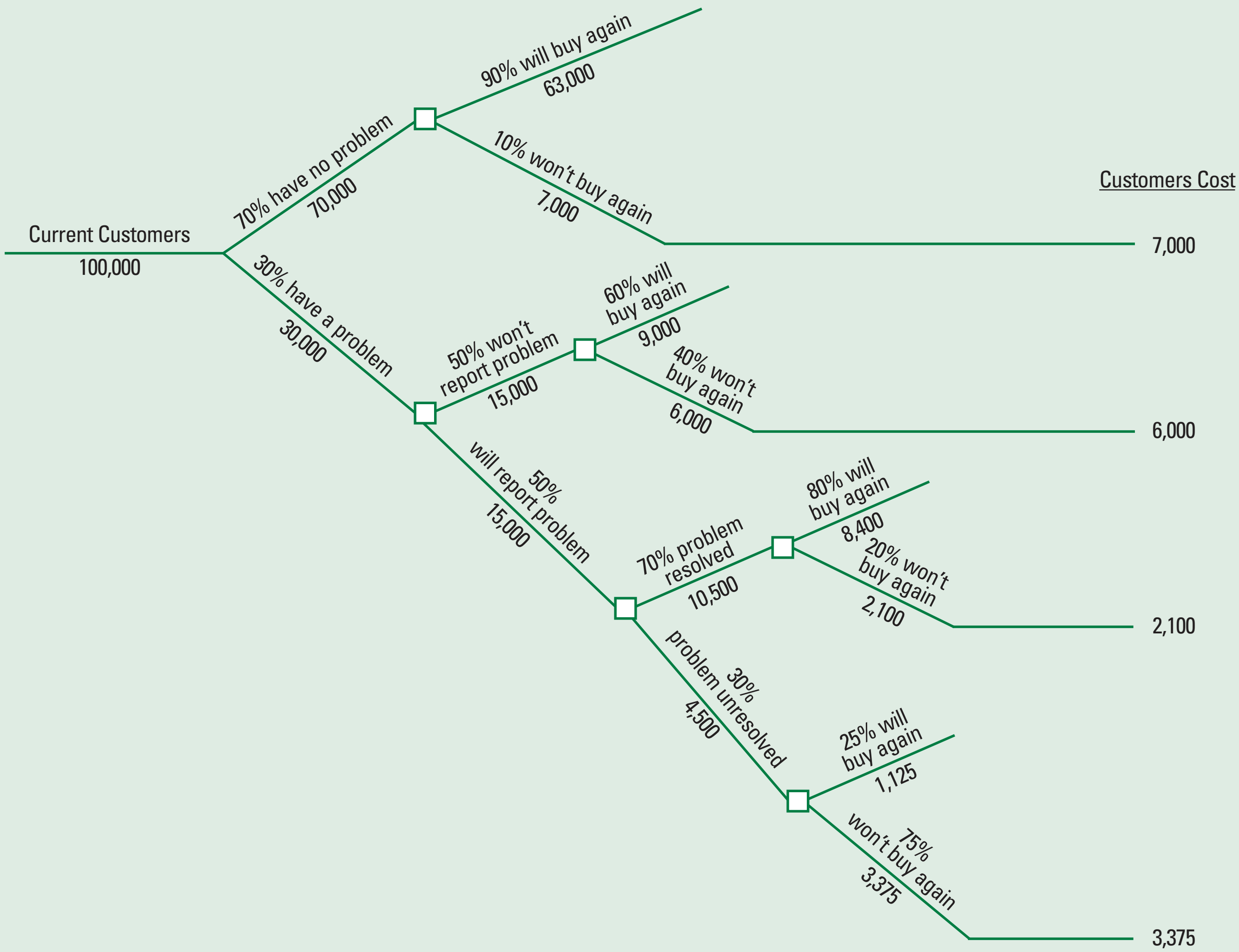
While 70% of Alpha's 100,000 customers (i.e., 70,000) do not experience a problem, 10% of that group (7,000) will not buy from Alpha again. The loss is much greater with those who have a problem. Among the 30,000 customers who have a problem, 50% (15,000) will not report the problem. This could be because of the perception that little is gained by reporting the problem and that no one bothers to help. Forty percent of these nonreporters (6,000) will not buy from Alpha again. Frustrated or dissatisfied, these customers just walk away without providing reasons for their defection.

As shown in Figure 1, Alpha Company could lose 18,475 customers per year, which translates into about $37 million (18,475 customers × $2,000 profit per customer = $36,950,000) in lost profits. If the average length of loyalty is five years, the potential undiscounted profit lost could be almost $185 million ($36,950,000 × 5 = $184,750,000), a staggering amount.

***Model 3: Estimating Customer Lifetime Value***

A customer's lifetime value (LTV) is the present value of profit streams over the life of a customer with the

Figure 1. **Problem Resolution and Lost Customers**




Based on Lakshmi Tatikonda and Rao J. Tatikonda, "Measuring and Reporting the Cost of Quality," *Production and Inventory Management Journal*, Second Quarter, 1996, pp. 1–7.

company. It provides a metric to track progress and assess the effectiveness of customer relations and satisfaction (CRM) programs. Sunil Gupta and Donald Lehman developed a simple method to estimate a customer's LTV that uses annual profit margin and a multiplier determined by dividing customer retention rate by 1 plus the discount rate (the company's cost of capital) minus the retention rate.[10] For example, if the annual profit margin is $2,000 and the multiplier is 4, then the LTV is $8,000 ($2,000 × 4).

Alpha Company implemented a $200 million customer improvement project that increased the customer retention rate to 85%. As a result of this increase, the new multiplier became 3.15. The new LTV for an Al-

Figure 2. **Lifetime Value of Alpha Customers**

**Prior to Customer Relations Improvement Project**

Discount Rate = 12%
Retention Rate = 80%
Customer Base = 100,000

$$\text{Multiplier} = \frac{80\%}{1 + (0.12 - 0.8)} = \frac{0.8}{0.32} = 2.50$$

The Lifetime Value of the customer = $2,000 × 2.50 = $5,000/customer

**LTV of the 100,000 Customers = $5,000 × 100,000 = $500,000,000**

Source: Sunil Gupta and Donald R. Lehman, *Managing Customers as Investments*, Wharton School Publishing, 2005.

**After the Customer Relations Improvement Project**

Discount Rate = 12%
Retention Rate = 85%
Customer Base = 100,000

$$\text{Multiplier} = \frac{85\%}{1 + (0.12 - 0.85)} = \frac{0.85}{0.27} = 3.15$$

The Lifetime Value of the customer = $2,000 × 3.15 = $6,300/customer

**LTV of the 100,000 Customers = $6,300 × 100,000 = $630,000,000**

pha customer is $6,300 (see Figure 2). The return on investment of the program was an impressive 65%.

Increase in LTV = $630,000,000 – $ 500,000,000 = $130,000,000

$$\text{Return on Investment} = \frac{\$130 \text{ million}}{\$200 \text{ million}} = 65\%$$

### Taking Action

While the models illustrated are imperfect, they provide a rough means to translate the intangible benefits of customer retention and show the potential impact that lost customers have on the bottom line. By measuring the consequences of customer dissatisfaction, these models serve as performance metrics and powerful communication tools.

Misunderstanding the nature and financial impact of customer satisfaction, lacking understanding of what drives customer loyalty, and making improvements that add little or no value to the customer lead to loss of customers and profits. Managers understand that customer dissatisfaction has a negative impact on a company, including lower profits, but they are often unaware of the measureable value of a customer.[11]

Inadequate accounting systems are part of the problem. The benefits of customer satisfaction and customer retention are reflected indirectly in the bottom line, but they are not reported directly anywhere in accounting systems. Generally Accepted Accounting Principles (GAAP) hide the value of loyal customers and their impact on profits. Marketing efforts typically focus on the 4Ps—product, price, placement, and promotion—that target new customers. This is inadequate for today's competitive business environment. Companies need to go beyond new customer acquisition. Higher profits come from keeping customers for a longer period of time and expanding overall market share. Loyal customers are less expensive to service, purchase more and premium-priced products, and their referrals and good word of mouth bring in new customers. The return on investment for customer retention improvement projects is significant.

Customer improvement programs that focus on customer retention lead to benefits such as better success in attracting new customers, better understanding of customer needs and timely responses, increased sales, and reduced costs.

There is a definite need to collect relevant data. Conducting surveys that ask yes or no questions such as "Are you happy with our product?" generally make managers feel good and give companies bragging rights about their customer satisfaction rates, but they provide very little relevant data about customer retention and repurchase intent. Asking action-related questions provides more relevant and reliable input from customers. Examples include:

- Are you going to buy from us again?
- Would you buy more from us?
- What percentage of your budget for products of this nature do you spend on our product?
- Would you recommend our product to your friends?

The data from those questions, along with other relevant metrics, can help a company create effective customer satisfaction and retention efforts. These generally include such actions as:

- Strengthening the customer service department.
- Specifying customer contact employees by name.
- Having toll-free telephone numbers.
- Following up and resolving customer conflicts quickly and fairly.
- Accepting errors and not arguing with customers.
- Empowering customer service personnel and providing them with appropriate and adequate training.
- Developing new and better accounting methods to measure customer value correctly.
- Using updated and relevant technology.
- Collecting relevant data to measure customer retention.
- Not aggravating customers with annoying auto-answer menus.

Using the models and combining them with relevant, actionable data can help provide managers with a clearer understanding of the missed opportunities and hidden costs that result from customer dissatisfaction. This more tangible picture can lead to a greater willingness to place increased emphasis and focus more resources on customer retention and satisfaction, potentially leading to increased profit and larger market share. ■

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